kotak Institutional Equities

Bharti Airtel (BHARTI)

Telecom

SELL

JUNE 29, 2011

CHANGE IN RECO.

Coverage view: Cautious

Price (Rs): 400

Target price (Rs): 345

BSE-30: 18,492

Lofty expectations, rich valuations, and willful blindness; downgrade to SELL.

We downgrade Bharti to SELL from REDUCE, noting risks on account of (1) lofty expectations – we see earnings downgrades ahead, (2) rich valuations which we believe will be questioned as earnings see downgrades, and (3) a willful blindness – to potential risks and the disconnect between top-down hope/belief/euphoria and bottom-up disappointments. We believe it's a matter of time before disappointing bottom-up indicators (versus lofty expectations) start challenging the near-euphoric top-down view.

Company data and valuation summary

Bharti Airtel

Stock data			
52-week range (Rs) (high,low)			428-261
Market Cap. (Rs bn)			1,520.2
Shareholding pattern (%)			
Promoters			68.3
FIIs			17.2
MFs			3.6
Price performance (%)	**1M**	**3M**	**12M**
Absolute	7.3	15.1	50.8
Rel. to BSE-30	6.0	17.9	45.0

Forecasts/Valuations	2011	2012E	2013E
EPS (Rs)	15.9	19.7	24.5
EPS growth (%)	(32.6)	23.9	24.1
P/E (X)	25.1	20.3	16.3
Sales (Rs bn)	594.7	725.3	826.8
Net profits (Rs bn)	60.5	74.9	93.0
EBITDA (Rs bn)	199.7	256.4	301.9
EV/EBITDA (X)	10.7	8.2	6.7
ROE (%)	13.3	14.3	15.3
Div. Yield (%)	0.0	0.0	0.0

Absolute upside demands earnings upgrades or multiple expansion – both legs are weak

Telecom sector's defensive positioning and a positive view on the direction of wireless business fundamentals in India (reducing competitive intensity and massive data upside potential being the key factors driving the stance) has driven sustained outperformance from Bharti and Idea in the past few months. Even as Idea has seen some earnings upgrades in this timeframe, uptick in Bharti has been purely driven by expansion of valuation multiples. At 8.2X 12-month forward EV/EBITDA, there is little margin of safety for potential risks of downgrades, regulatory shocks, and disappointment on data growth story versus expectations (magnitude or timeline or associated capex). Earnings upgrade probability is low, as we discuss in the next point.

Risk #1 – lofty expectations, challenging ask-rate; higher probability of downgrades than upgrades

Bharti's FY2012/13E estimates have broadly remained the same over the past few quarters despite miss on estimates through FY2011. Actual FY2011 EBITDA and EPS came in 9% and 20% lower than our estimates in July 2010 – post Zain acquisition; we believe the miss would be similar versus consensus as well. Of course, stocks discount the future and not the past and we understand that. However, past sets a base and a lower base increases the ask rate in the future, as is the case now with Bharti. Meeting FY2012E estimates (consensus consol. EBITDA of Rs249 bn and EPS of Rs21) looks challenging to us – competitive scenario needs to continue improving in line with market expectations and Bharti's execution, both in India/South Asia as well as Africa needs to be spot on. Estimates cannot take the burden of even a single quarter of miss from hereon.

Risk #2 – rich valuations

At 8.2X 12-month forward EV/EBITDA and 20.4X P/E, Bharti trades at substantial premium to other EM telcos. We do not agree with the 'high EBITDA growth in FY2012/13E' as a supportive argument for the high multiple – a multiple applied to FY2012/13E EBITDA should not depend on growth in FY2012/13E, but growth beyond that. Growth in FY2012/13E is already reflected in the EBITDA base used in the EV = EBITDA * EV/EBITDA equation. From a 5-7 years perspective, we believe the Indian wireless market will struggle to grow beyond high single digit CAGR.

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Risk #3 – willful blindness to risks

The urge to be positive on Bharti, we believe, is leading to what Margaret Heffernan terms as 'willful blindness' in her book with the same title. She says 'the biggest threats and dangers are often the ones we don't see – not because they're secret or invisible, but because we are willfully blind'. Sample these

- Blaming increase in competitive intensity in the market for Bharti's wireless revenue market share loss in the past 8-odd quarters (360 bps lost through March 2011 from the peak levels hit in June 2009), there is an unwillingness to look at the massive relative market share loss for Bharti versus an Idea or a Vodafone – the other two incumbents who have managed to increase their market share in the same timeframe. Also, Voda/Idea's market share gains have not been limited to their 'new' circles; they have gained market share in some of their leadership circles as well, unlike a Bharti which has lost market share in most of its leadership circles.

- Bharti has not grown its India wireless EBITDA for the past 7 quarters. Its wireless EBITDA for the March 2011 quarter was 7.3% below June 2009 levels and more importantly lower than June 2010 levels – operating environment has been benign since June 2010 and hence, Bharti's flattish wireless EBITDA for the past three quarters is even more disappointing. We note that Idea has grown its wireless EBITDA at a 2% CQGR over the June 2009 – March 2011 timeframe.

- Of the three metrics that broadly capture wireless business performance viz. RPM change, minutes growth, and margin movement, Bharti has disappointed on at least two in each of the past seven quarters. Its India/SA wireless EBITDA margin has corrected a cumulative 715 bps over this period. Also important is to understand the volume/pricing trade-off that a player like Bharti faces – it has done well on volumes in quarters where it has taken an RPM hit while it has seen muted volume growth in quarters where it has held on to RPMs (see Exhibit 1). Even as it is fair to say that this trade-off has been a market reality, it is starker for Bharti for two reasons – (1) revenue leadership position in most circles, and (2) lower-than-peers volume-growth-led operating leverage on margins. Street's tendency to latch on to the one positive (of the three metrics mentioned earlier) while ignoring the negative trend in the other two has been particularly amusing to us.

Exhibit 1: Bharti - the RPM/traffic growth/ margins trade-off

	Jun-09	Sep-09	Dec-09	Mar-10	Jun-10	Sep-10	Dec-10	Mar-11
Revenues (Rs mn)	**84,301**	**82,902**	**80,898**	**83,174**	**88,237**	**88,045**	**91,459**	**94,948**
Growth qoq (%)		(1.7)	(2.4)	2.8	6.1	(0.2)	3.9	3.8
EBITDA (Rs mn)	**34,106**	**33,310**	**30,400**	**30,237**	**31,710**	**30,964**	**31,954**	**31,620**
Growth qoq (%)		(2.3)	(8.7)	(0.5)	4.9	(2.4)	3.2	(1.0)
EBITDA margin (%)	**40.5**	**40.2**	**37.6**	**36.4**	**35.9**	**35.2**	**34.9**	**33.3**
Change qoq (bps)		(28)	(260)	(122)	(42)	(77)	(23)	(164)
Minutes (mn)	**140,713**	**143,680**	**153,241**	**172,797**	**190,396**	**190,767**	**199,146**	**211,822**
Growth qoq (%)		2.1	6.7	12.8	10.2	0.2	4.4	6.4
RPM (Rs/min)	**0.582**	**0.561**	**0.517**	**0.470**	**0.448**	**0.444**	**0.442**	**0.431**
Growth qoq (%)		(3.7)	(7.8)	(9.1)	(4.6)	(0.9)	(0.6)	(2.4)

Source: Company, Kotak Institutional Equities

- Investments in 3G spectrum is suddenly being looked at as an NPV-positive one. We are believers in the data (volume) growth story in the Indian market in the coming years. However, 'volume growth = NPV accretion' is a rather simplistic assumption and fails to factor in (1) the price paid for the spectrum, (2) price points necessary for the volume assumptions to pan out – this has major bearing on incremental EBITDA margins from data, and (3) necessary capex to support the volume growth. More importantly, Bharti's decision to let go of 3G spectrum in 9 circles, including some high-3G-potential ones like Gujarat, Kerala, Punjab, Maharashtra, etc. (see Exhibit 2) appears inexplicable if Bharti's 3G offerings in the other 13 circles generates the sort of positive NPV that market has now started factoring in. Bharti would (or should, in our view) have been perfectly happy with leaving this NPV upside on the table to win 3G spectrum in other circles. Its balance sheet allowed it that luxury and more importantly such a move would have weakened the balance sheets of competitors in the process, thereby gaining Bharti some bonus NPV in the 2G market.

Exhibit 2: Bharti has won 3G spectrum in only 6 of its top 10 circles
Less that 70% of its current revenues come from circles where Bharti has 3G spectrum

Circle	% of Bharti Mar-11 GR	Bharti's RMS in the circle (Mar 2011, %)	Bharti's RMS rank in the circle (Mar 2011, #)	Circle contribution to pan-India wireless revenues (%)	3G Spectrum(Yes/No)	BWA Spectrum(Yes/No)
Karnataka	11.2	47.6	1	7.1	✓	✓
Andhra Pradesh	10.6	39.5	1	8.1	✓	✗
Delhi	8.9	33.4	1	8.1	✓	✗
TN (incl Chennai)	8.5	30.5	1	8.4	✓	✗
Bihar	7.3	44.6	1	4.9	✓	✗
Rajasthan	7.2	45.4	1	4.8	✓	✗
U.P. (E)	**5.7**	**28.8**	**2**	**6.0**	✗	✗
Maharashtra	**5.0**	**19.2**	**3**	**7.9**	✗	✓
Punjab	**4.7**	**36.9**	**1**	**3.8**	✗	✓
Madhya Pradesh	**4.2**	**28.1**	**2**	**4.5**	✗	✗
Mumbai	4.2	18.5	2	6.9	✓	✗
Gujarat	**3.5**	**18.6**	**2**	**5.7**	✗	✗
West Bengal	2.9	22.6	3	3.9	✓	✗
Orissa	**2.6**	**35.5**	**1**	**2.2**	✗	✗
U.P. (W)	2.5	18.0	3	4.2	✓	✗
Kerala	**2.5**	**17.4**	**3**	**4.3**	✗	✗
Kolkata	**1.9**	**23.3**	**2**	**2.5**	✗	✓
Assam	1.9	33.5	1	1.7	✓	✗
North East	1.4	38.7	1	1.1	✓	✗
J&K	1.3	40.7	1	1.0	✓	✗
Haryana	**1.2**	**18.2**	**3**	**2.0**	✗	✗
Himachal Pradesh	0.9	37.7	1	0.7	✓	✗
All India	**100.0**	**30.3**		**100.0**		

Source: TRAI, Kotak Institutional Equities

- Similar case with Africa – our January 6, 2011 detailed note on Bharti Africa looks at the pitfalls of the Street's hurry in assigning a neutral or positive NPV to the company's Africa acquisition. We are not suggesting that this cannot be the case, but there are meaningful challenges and we need more proof points than just management targets (and extrapolation of the same) to start ascribing positive NPV to the acquisition. The ease with which Bharti's incumbency in India is touted as an advantage while expecting Bharti to overcome such advantage with other players in key African markets surprises us.

- Finally, regulations – It is important to appreciate the basic premise of the current regulatory mess in the Indian wireless industry – a national resource, in the form of 2G wireless spectrum, was sold at below its fair value (as per CAG and other reports – we do not intend to define what is fair value, here) to telecom operators. This premise applies as much to excess spectrum grants to larger incumbents as it does to the new start-up/dual-tech license/spectrum grants (which may involve instances of graft – but that is a separate issue). Now, whichever way the tide turns for the new entrants embroiled in this issue, one thing looks near-certain to us – the price of spectrum (for any future grants or renewals) is bound to increase for the sector. Relative implications of this favor incumbents in the near term, one can argue, as some of the new operators may be forced to surrender their licenses and spectrum. However, increase in raw material cost for the industry impacts everyone on an absolute basis. More importantly, the risk that fair pricing of spectrum takes into consideration the spectral quality of 900 MHz spectrum etc. has the potential to hurt incumbents more than the larger challengers like RCOM, Aircel, and TTSL – this risk could play out in terms of spectrum refarming and/or higher pricing of 900 MHz spectrum. Another round of termination rate cut is also possible. Market, in the charitable mood on telcos that it is in, has adopted the 'will worry about negatives when they come' approach, in our view.

The 'meeting expectations' challenge

We see a serious risk of downgrades to consensus earnings expectations for Bharti for FY2012E. To begin with, we see disconnect between consensus EBITDA and EPS estimates for FY2012E – these (per Bloomberg) stand at Rs249 bn and Rs21/share, respectively. Exhibit 3 below works backwards from various EPS scenarios for FY2012E and builds in reasonably visible pressure in below-EBITDA line items (mostly on account of 3G-related increased amortization and interest expenses, which were capitalized for a bulk of FY2011E) to arrive at required EBITDA levels to deliver specific EPS levels.

Exhibit 3: Bharti - the 'meeting expectations' challenge

Rs mn	4QFY11			FY2012E				
EPS (Rs/share)	**3.7**	**19.0**	**20.0**	**21.0**	**22.0**	**23.0**	**24.0**	**25.0**
# shares (mn)	3,798	3,798	3,798	3,798	3,798	3,798	3,798	3,798
PAT	**14,007**	**72,154**	**75,952**	**79,750**	**83,547**	**87,345**	**91,142**	**94,940**
Minorities	701	2,804	2,804	2,804	2,804	2,804	2,804	2,804
Taxes	(4,996)	(23,117)	(24,383)	(25,649)	(26,914)	(28,180)	(29,446)	(30,712)
ETR (%)	**27.3**	**25.0**	**25.0**	**25.0**	**25.0**	**25.0**	**25.0**	**25.0**
PBT	18,302	92,467	97,531	102,594	107,658	112,721	117,785	122,848
Net interest expense	**(6,438)**	**(31,142)**	**(31,142)**	**(31,142)**	**(31,142)**	**(31,142)**	**(31,142)**	**(31,142)**
EBIT	24,740	123,609	128,673	133,736	138,800	143,863	148,927	153,990
Depreciation	**(24,887)**	**(106,746)**	**(106,746)**	**(106,746)**	**(106,746)**	**(106,746)**	**(106,746)**	**(106,746)**
Amortization	**(4,870)**	**(25,129)**	**(25,129)**	**(25,129)**	**(25,129)**	**(25,129)**	**(25,129)**	**(25,129)**
EBITDA	**54,496**	**255,484**	**260,548**	**265,611**	**270,675**	**275,738**	**280,802**	**285,865**
EBITDA CQGR required (%)		**6.5**	**7.3**	**8.1**	**8.9**	**9.6**	**10.4**	**11.1**
Africa EBITDA (10% CQGR from 4Q11)	**10,153**	**51,832**	**51,832**	**51,832**	**51,832**	**51,832**	**51,832**	**51,832**
India EBITDA	**44,343**	**203,652**	**208,715**	**213,779**	**218,842**	**223,906**	**228,969**	**234,033**
India EBITDA CQGR required (%)		**5.6**	**6.6**	**7.6**	**8.6**	**9.5**	**10.5**	**11.4**

Source: Kotak Institutional Equities estimates

As can be seen from highlighted box in the Exhibit above, delivering Rs21/share of EPS demands an EBITDA of Rs266 bn in FY2012E. This implies an EBITDA CQGR of 8.1% at consolidated level through 1Q-4QFY12E. Even assuming that Bharti Africa delivers a 10% EBITDA CQGR for the next 4 quarters, the CQGR ask rate on India business EBITDA is a lofty 7.6%. Now, non-wireless businesses in India (including passive infrastructure) are unlikely to grow anywhere close to these CQGR levels and hence, the ask rate on India wireless EBITDA is even higher – saying this is impossible would be incorrect, but ignoring the extent of challenge in meeting these estimates is fraught with substantial risk as well. Suffice to say, we see risks to even our EPS estimate of Rs19.7/share and our estimate is a good 6% lower than consensus.

Bharti's disappointing India wireless performance in recent quarters – more than just competitive intensity

When looking at Bharti's India wireless business, it is important to think beyond the normal definition of incumbents and challengers in the business. One simple reason – Bharti's return ratios are substantially (at least 15 percentage points) better than the 2nd (Vodafone) and 3rd (Idea) largest players in the market in revenue market share (RMS) terms. It would not be unfair to include Vodafone and Idea in the challenger category when thinking about sustainability of Bharti's RMS. Relative RMS movement over the past couple of years lends credence to this thesis – it is Vodafone and Idea that have caused more damage to Bharti's RMS than the new challengers. TTSL, Aircel, and Uninor have of course caused some damage but that has been more than offset by poor performance from RCOM and BSNL. Here are a few data points to substantiate our point (Exhibits 4-9 at the end of this section depict these in detail) –

- Before jumping into numbers, we clarify that we have used TRAI's reported quarterly revenue data for our analysis. This has two flaws – (1) revenues reported to the regulator do not tally with the revenues reported to the investor community for the listed entities – the difference is especially stark in case of RCOM, and (2) revenues reported to the regulator are UAS license revenues and not 'pure wireless' revenues – discrepancy exists in case of Bharti, TTSL, and RCOM whose fixed-line voice revenues are included in UASL revenues reported to the TRAI. Nonetheless, given that we are analyzing trends or change in market share here, this in no way has a material impact on our analysis.

- Bharti's pan-India RMS peaked out at 33.9% in Jun 2009. It has come down a sharp 360 bps in the seven quarters since to touch 30.3% in March 2011. Bulk (nearly 220 bps) of the decline in market share has happened in the three quarters since June 2010.

- Ranked by RMS, Bharti was #1 in 14 circles, #2 in 6 and #3 in 2 in June 2009. In March 2011, it was #1 in 12 (a drop of 2), # 2 in 5 (a drop of 1), and #3 in the remaining 5 circles.

- Circle-wise, Bharti has lost 380 bps RMS in Metros+A circles (~55% of industry revenues), and a sharp 760 bps RMS in the C circles. We note that the company was among the top-2 players in all of Metro, A, and C circles. Even in the B circles, where the company has been relatively weaker in terms of RMS, it has lost 220 bps in RCOM since June 2009.

- Some of the key circles where the **company has lost leadership ranks** include large ones like Maharashtra, Kolkata, Kerala, M.P., and Haryana. It is important to note who Bharti has lost leadership to – in Maharashtra, Kolkata, and Haryana, it is to Vodafone and in Kerala and M.P., it is to Idea. We note that these circles only represent the ones where Bharti has lost RMS rank. It has lost RMS in several more – we discuss this next.

- Since June 2009, Bharti has lost RMS in all but one circle (UP (west), where it has gained a modest 25 bps). In absolute terms, the largest RMS loss has been in circles like J&K, Orissa, H.P., and Kolkata. On a weighted average basis (which we compute as change in market share multiplied by circle's contribution to Bharti's revenues in June 2009), Bharti has seen substantial RMS loss in key circles like Karnataka, Delhi, Tamil Nadu, and Bihar, in addition to the ones mentioned above.

Now coming to the key point – what has led to the all-around RMS loss for Bharti over the past (almost) two years? Wasn't it supposed to be the case with several new network rollouts (RCOM/TTSL GSM, Aircel expansion, Idea/ Voda expansion, Uninor) happening? The answer is – yes and no. Even as Aircel and TTSL, among the new GSM operators, have managed a 150 bps RMS gain each since June 2009, not all incumbents have lost. Bharti is the RMS loss leader along with RCOM and BSNL. The other two incumbents, Vodafone and Idea have in fact managed to gain RMS in this timeframe – Voda to 21.5% from 20.8%, and Idea to 13.7% from 12.2%. And lest one attribute Voda's and Idea's RMS gain to their expansion into pan-India players, it is instructive to note that both these operators have done an excellent job in protecting and in some cases gaining RMS in their leadership circles as well. A few data points

- Idea was in the top-4 by RMS in 9/22 circles in June 2009 – it is now a top-4 player in 13. Its RMS in its leadership circles (where it was #1 in June 2009) has gone up from 28.1% to 29% and it has also increased its market share in circles where it was #2/#3.

- Vodafone, though it has lost around 150 bps of RMS in circles where it was #1 in June 2009, has managed to increase RMS in circles where it was #2/#3. The number of circles where it is among the top-2 operators by RMS has gone up to 12 in March 2011 from 10 in June 2009.

- Bharti's relative revenue market share versus Vodafone and Idea has seen a meaningful decline since June 2009. Its relative market share (assuming these are the only three players that form the market) has fallen almost 440 bps from levels of 50.7% in June 2009 to 46.3% in Mar 2011 – Vodafone has gained 170 bps of this while Idea has gained the remaining 270 bps.

- Even as Vodafone and Idea expanding into new circles has helped, Bharti has seen relative market share loss versus these two players in legacy circles as well. For example, excluding the C circles (where Voda is a new entrant), Vodafone's revenues in its 16 old circles is now 80% of Bharti as compared to 70% in June 2009. Note that these 16 circles are ~85% of Bharti's revenues. Similarly, Idea's revenues in its 13 established circles are now 59% of Bharti's revenues in these circles as compared to 49% in June 2009 and 45% in September 2008.

Bharti's relative wireless growth challenge is not limited to revenues alone. As highlighted in some of our recent notes, Bharti has struggled to grow its India wireless EBITDA for several quarters now. Its India (and South Asia) wireless EBITDA is still 7% below June 2009 levels; and as mentioned on the opening page of this note, it has been flat for the past three quarters as well – quarters when competitive intensity has been stable. It is important to note here that Idea has seen reasonable EBITDA growth in this timeframe. RMS loss is one part of the equation – the other, equally critical impediment to EBITDA growth for Bharti has been declining (and now nearly non-existent, at least on the voice side of the business) scale-led cost leverage. We discuss this next.

Exhibit 4: Bharti has lost RMS in all but one circle; Voda and Idea have done well, even in their leadership circles

Circle	Bharti				Vodafone				Idea			
	% of Rev	Market share (%)		Change	% of Rev	Market share (%)		Change	% of Rev	Market share (%)		Change
	Mar-11	Jun-09	Mar-11	(bps)	Mar-11	Jun-09	Mar-11	(bps)	Mar-11	Jun-09	Mar-11	(bps)
Metro + Circle A	**53.8**	**33.6**	**29.8**	**(388)**	**60.4**	**23.2**	**23.7**	**52**	**49.9**	**11.0**	**12.5**	**142**
Andhra Pradesh	10.6	40.1	39.5	(63)	4.2	13.7	11.0	(272)	9.8	17.7	16.5	(115)
Delhi	8.9	38.6	33.4	(519)	10.1	22.9	26.9	399	6.2	9.7	10.5	80
Gujarat	3.5	21.1	18.6	(246)	10.6	40.7	39.7	(100)	7.5	17.6	17.9	31
Karnataka	11.2	54.0	47.6	(641)	4.6	16.0	13.9	(210)	4.3	6.2	8.2	209
Kolkata	1.9	32.2	23.3	(887)	3.6	32.1	30.7	(141)	0.5	-	2.8	276
Maharashtra	5.0	23.4	19.2	(418)	8.5	18.8	22.9	412	16.9	28.7	29.2	48
Mumbai	4.2	20.7	18.5	(224)	10.1	31.5	31.5	(7)	3.6	3.9	7.1	315
TN (incl Chennai)	8.5	34.3	30.5	(383)	8.9	21.3	22.5	129	1.1	0.0	1.8	172
Circle B	**30.8**	**30.0**	**27.8**	**(214)**	**34.4**	**22.1**	**22.0**	**(2)**	**45.4**	**17.1**	**18.5**	**137**
Haryana	1.2	19.9	18.2	(171)	2.7	25.4	27.9	255	3.0	20.1	20.3	15
Kerala	2.5	21.2	17.4	(376)	4.4	19.6	22.0	233	9.6	28.0	30.6	254
Madhya Pradesh	4.2	32.1	28.1	(401)	0.9	2.6	4.5	190	10.0	28.6	30.1	158
Punjab	4.7	38.8	36.9	(191)	3.2	16.1	17.6	153	5.4	18.0	19.1	112
Rajasthan	7.2	45.7	45.4	(32)	5.0	23.1	22.3	(76)	3.3	5.7	9.4	369
U.P. (E)	5.7	29.1	28.8	(32)	8.1	32.1	29.4	(273)	5.0	8.5	11.5	307
U.P. (W)	2.5	17.8	18.0	25	4.8	25.0	24.1	(87)	8.4	27.1	27.2	13
West Bengal	2.9	29.0	22.6	(634)	5.4	36.3	30.1	(618)	0.7	-	2.5	247
Circle C	**15.4**	**47.5**	**39.9**	**(761)**	**5.1**	**3.5**	**9.5**	**595**	**4.7**	**2.5**	**5.5**	**298**
Assam	1.9	35.7	33.5	(218)	0.8	2.7	10.0	732	0.2	-	1.9	189
Bihar	7.3	49.8	44.6	(522)	2.3	4.0	9.9	595	3.3	4.7	9.1	435
Himachal Pradesh	0.9	46.9	37.7	(926)	0.2	2.6	6.7	410	0.4	6.1	6.8	70
J&K	1.3	68.2	40.7	(2,748)	0.3	1.5	7.3	574	0.1	-	1.8	179
North East	1.4	39.0	38.7	(34)	0.5	4.1	9.5	535	0.2	-	2.1	208
Orissa	2.6	45.6	35.5	(1,004)	1.0	4.1	9.8	574	0.5	0.8	3.2	238
Pan India	**100.0**	**33.9**	**30.3**	**(357)**	**100.0**	**20.8**	**21.5**	**70**	**100.0**	**12.2**	**13.7**	**151**

Note:
(a) Circles shaded in pink represent the top-5 circles for each operator.

Source: TRAI, Kotak Institutional Equities

Exhibit 5: Bharti market share by revenue & subscribers

	Jun-09	Sep-09	Dec-09	Mar-10	Jun-10	Sep-10	Dec-10	Mar-11
Revenue market share (%)								
Metros + Circle A	33.6	33.1	32.6	31.6	32.5	31.4	31.1	29.8
Circle B	30.0	29.6	28.9	28.7	29.3	28.7	28.6	27.8
Circle C	47.5	45.7	41.3	39.1	41.7	41.0	40.6	39.9
Total	**33.9**	**33.3**	**32.3**	**31.5**	**32.5**	**31.6**	**31.3**	**30.3**
Subscriber market share (%)								
Metros + Circle A	23.9	23.1	22.3	21.5	20.9	20.1	19.4	19.2
Circle B	21.5	21.4	21.0	20.4	20.2	19.7	19.4	18.9
Circle C	34.3	33.2	30.9	29.2	29.0	28.4	27.3	27.1
Total	**24.3**	**23.7**	**22.9**	**22.1**	**21.7**	**21.0**	**20.4**	**20.1**

Source: TRAI, Kotak Institutional Equities

Exhibit 6: Idea has been gaining in terms of relative performance over Bharti

	Jun-09	Sep-09	Dec-09	Mar-10	Jun-10	Sep-10	Dec-10	Mar-11
Wireless revenues (Rs mn)								
Bharti	84,301	82,902	80,898	83,174	88,237	88,045	91,459	94,948
Idea	28,883	28,909	30,610	33,011	36,897	36,891	39,901	42,692
Idea as % of Bharti	**34.3**	**34.9**	**37.8**	**39.7**	**41.8**	**41.9**	**43.6**	**45.0**
Wireless EBITDA (Rs mn)								
Bharti	34,106	33,310	30,400	30,237	31,710	30,964	31,689	31,620
Idea	7,700	7,307	7,203	8,328	7,937	7,618	8,064	8,785
Idea as % of Bharti	**22.6**	**21.9**	**23.7**	**27.5**	**25.0**	**24.6**	**25.4**	**27.8**
Total minutes (mn)								
Bharti	140,713	143,680	153,241	172,797	190,396	190,767	199,146	211,822
Idea	48,729	50,339	57,841	68,275	82,274	84,828	93,503	101,960
Idea as % of Bharti	**34.6**	**35.0**	**37.7**	**39.5**	**43.2**	**44.5**	**47.0**	**48.1**
RPM (Rs/min)								
Bharti	0.58	0.56	0.52	0.47	0.45	0.44	0.44	0.43
Idea	0.58	0.56	0.51	0.46	0.44	0.42	0.42	0.41
Idea as % of Bharti	**99.9**	**99.4**	**99.5**	**98.9**	**97.8**	**95.4**	**94.8**	**94.0**
Cost per min (Rs/min)								
Bharti	0.34	0.33	0.32	0.29	0.28	0.28	0.28	0.28
Idea	0.42	0.41	0.39	0.34	0.34	0.33	0.33	0.31
Idea as % of Bharti	**124.7**	**125.4**	**122.3**	**116.3**	**121.4**	**118.4**	**117.1**	**110.8**

Source: Companies, Kotak Institutional Equities

Exhibit 7: Vodafone’s market share gains over Bharti have not been limited to their ’new’ circles

	Jun-09	Sep-09	Dec-09	Mar-10	Jun-10	Sep-10	Dec-10	Mar-11
16 established circles								
Bharti	76,240	74,993	74,091	74,988	79,646	78,148	81,224	80,765
Vodafone	53,756	52,562	53,582	56,256	58,763	58,780	61,561	64,189
Vodafone as % of Bharti	**70.5**	**70.1**	**72.3**	**75.0**	**73.8**	**75.2**	**75.8**	**79.5**
6 new circles								
Bharti	12,888	12,743	11,707	12,440	13,550	13,500	13,854	14,652
Vodafone	949	1,247	1,635	2,124	2,569	2,831	3,067	3,469
Vodafone as % of Bharti	**7.4**	**9.8**	**14.0**	**17.1**	**19.0**	**21.0**	**22.1**	**23.7**
Total								
Bharti	89,128	87,735	85,798	87,428	93,196	91,649	95,078	95,417
Vodafone	54,705	53,809	55,216	58,379	61,332	61,611	64,628	67,657
Vodafone as % of Bharti	**61.4**	**61.3**	**64.4**	**66.8**	**65.8**	**67.2**	**68.0**	**70.9**

Source: TRAI, Kotak Institutional Equities

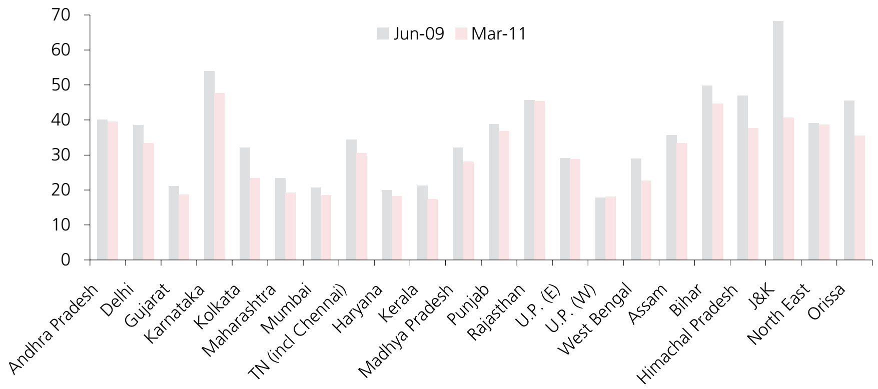
Exhibit 8: Same story in case of Idea's relative market share gains over Bharti

	Jun-09	Sep-09	Dec-09	Mar-10	Jun-10	Sep-10	Dec-10	Mar-11
Established circles								
Bharti	60,437	59,021	58,588	59,470	63,347	61,862	64,326	64,943
Idea	30,669	30,149	31,438	32,353	34,398	33,850	36,625	38,696
Idea as % of Bharti	**50.7**	**51.1**	**53.7**	**54.4**	**54.3**	**54.7**	**56.9**	**59.6**
New circles								
Bharti	28,691	28,714	27,211	27,958	29,849	29,787	30,752	30,474
Idea	1,349	1,714	2,270	2,658	3,006	3,323	3,931	4,374
Idea as % of Bharti	**4.7**	**6.0**	**8.3**	**9.5**	**10.1**	**11.2**	**12.8**	**14.4**
Total								
Bharti	89,128	87,735	85,798	87,428	93,196	91,649	95,078	95,417
Idea	32,018	31,864	33,708	35,011	37,404	37,173	40,556	43,070
Idea as % of Bharti	**35.9**	**36.3**	**39.3**	**40.0**	**40.1**	**40.6**	**42.7**	**45.1**

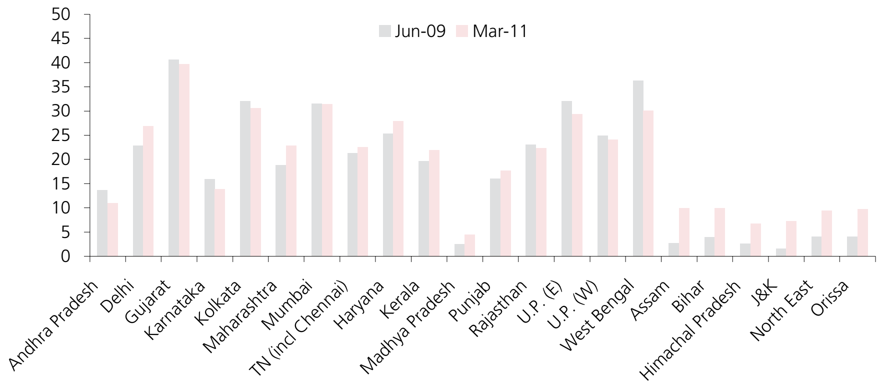
Source: TRAI, Kotak Institutional Equities

Exhibit 9: Circle-wise RMS for Bharti, Vodafone, and Idea - March 2011 versus June 2009

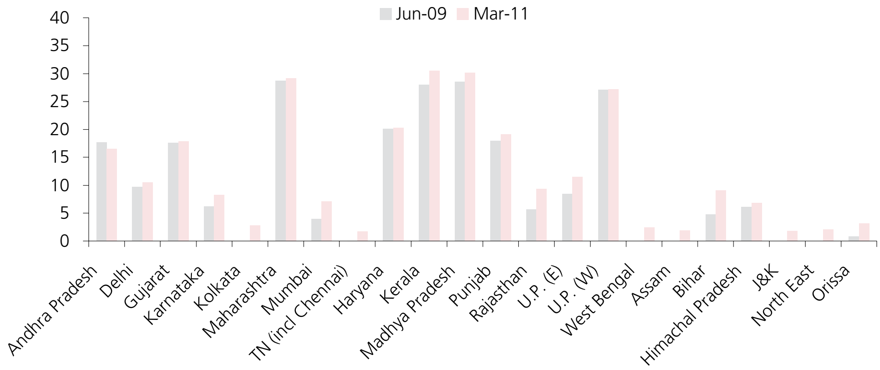
Bharti



Vodafone



Idea

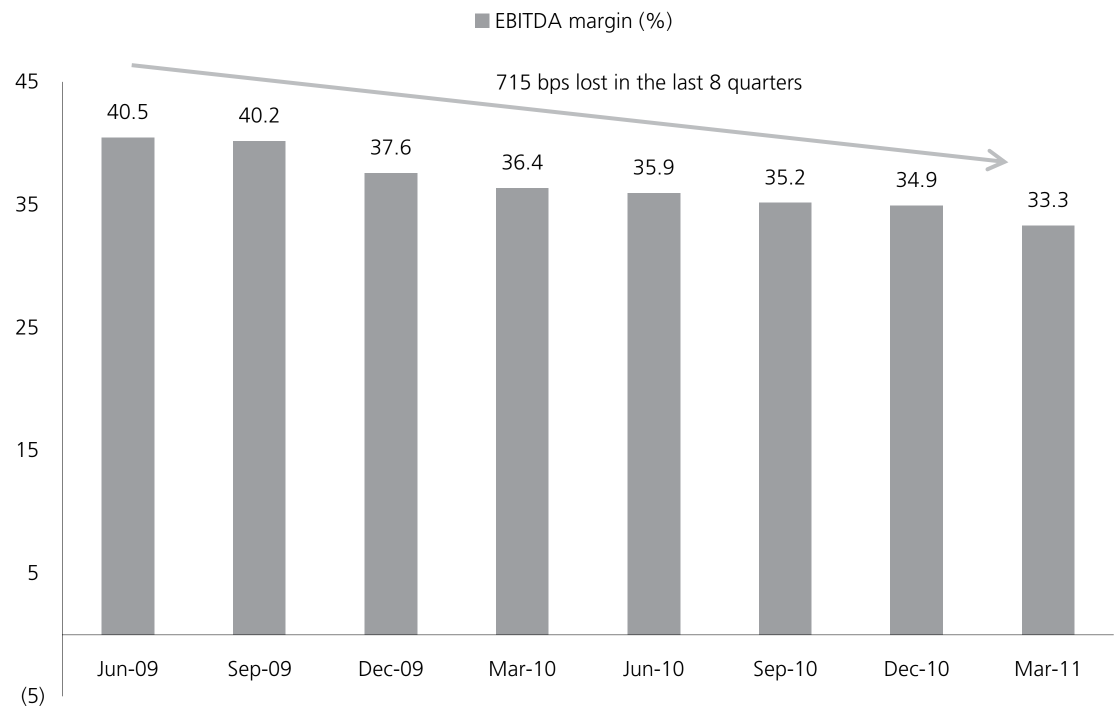


Source: TRAI, Kotak Institutional Equities

Has operating leverage on the voice-side played out for Bharti?

As noted earlier in the piece, Bharti's India wireless EBITDA margin has fallen every single quarter for the past seven quarters – a cumulative fall of 715 bps over the timeframe (see Exhibit 10). More importantly, 260 bps of this fall has occurred over the past three quarters, when RPM has been relatively stable. Bharti's cost per minute, and this is an important point to note, has remained flat for the past four quarters, despite a reasonable growth in network traffic. Nothing to take away from Bharti here – they run the most efficient network in the industry and are the clear leaders on the cost per minute metric. However, like many other businesses and companies, there is a penalty for industry-leading efficiency – incremental efficiencies become harder to come by.

Exhibit 10: Bharti's India/SA wireless margins have fallen in each of the past seven quarters



Source: Company, Kotak Institutional Equities

Bharti today carries 30% higher minutes per cell site as compared to an Idea (see Exhibit 11). We do not know if Bharti's absolute levels of 614,000 minutes carried per cell site per month (for the March 2011 quarter) has scope for improvement or not. What we do believe is that others like Idea and Vodafone, who are running at lower network utilization levels, can be more aggressive on chasing volume growth as they have relatively higher operating leverage left.

Exhibit 11: Bharti's cost per minute in the India wireless business has been flat for the past four quarters

	Jun-09	Sep-09	Dec-09	Mar-10	Jun-10	Sep-10	Dec-10	Mar-11
Bharti								
# of cell sites (#)	96,149	99,501	102,190	104,826	105,394	110,038	113,587	116,261
Total volume of minutes carried (bn)	140,713	143,680	153,241	172,797	190,396	190,767	199,146	211,822
Minutes per cell site per month ('000)	**495**	**490**	**507**	**556**	**604**	**590**	**594**	**614**
Revenues (mn)	84,301	82,902	80,898	83,174	88,237	88,045	91,459	94,948
Revenue per cell site per month ('000)	296,547	282,484	267,399	267,850	279,824	272,460	272,656	275,394
Cost per cell site- excl depreciation (Rs)	176,572	168,982	166,915	170,476	179,263	176,640	178,185	183,681
Cost per minute (Rs/min)	**0.340**	**0.329**	**0.319**	**0.295**	**0.282**	**0.282**	**0.283**	**0.282**
Idea (a)								
# of cell sites (#)	48,067	50,915	55,804	66,187	66,725	67,980	70,208	73,668
Total volume of minutes carried (bn)	48,729	50,339	57,841	68,275	82,274	84,828	93,503	101,960
Minutes per cell site per month ('000)	**352**	**339**	**361**	**373**	**413**	**420**	**451**	**472**
Revenues (mn)	28,883	28,909	30,610	34,000	36,897	36,891	39,901	42,691
Revenue per cell site per month ('000)	208,624	194,709	191,219	185,806	185,070	182,577	192,496	197,814
Cost per cell site- excl depreciation (Rs)	153,006	145,494	146,222	134,890	145,259	144,875	152,869	153,822
Cost per minute (Rs/min)	**0.423**	**0.412**	**0.390**	**0.343**	**0.342**	**0.334**	**0.331**	**0.312**

Note:
(a) Spice financials are consolidated with Idea from Feb-2010

Source: Companies, Kotak Institutional Equities

Margin expansion for Bharti from hereon will depend on the pace of 3G revenue pick-up. Do note that we have not used the term 'non-voice revenues' here – our caution comes from historical data points. Bharti has seen substantial non-voice revenue growth over the past seven quarters – a CQGR of 8.7% versus 0.6% for voice – margins have still declined a cumulative 715 bps, as discussed earlier (see Exhibit 12). However, we should mention here that we do not subscribe to Bharti's '80% incremental EBITDA margin on 3G revenues' assertion; for two reasons – (1) such margin level assumes absolutely zero incremental network opex as 20% of incremental 3G revenues will barely cover incremental regulatory and sales (channel) expenses, and (2) 80% margin on any service in a market as competitive as India wireless is just unsustainable; what will a TTSL/RCOM/Aircel/BSNL do with a 80% EBITDA margin if they do not have enough revenues?

Exhibit 12: Bharti - voice and non-voice revenue trends over the past few quarters

	Jun-09	Sep-09	Dec-09	Mar-10	Jun-10	Sep-10	Dec-10	Mar-11	CQGR (Jun 2009 - Mar 2011) (%)
India wireless revenues (Rs mn)	81,882	80,538	79,216	81,174	85,356	84,786	88,003	91,364	1.6
Voice (Rs mn)	**74,251**	**72,633**	**70,476**	**71,628**	**75,474**	**74,007**	**75,872**	**77,660**	**0.6**
Growth qoq (%)	**(0.4)**	**(2.2)**	**(3.0)**	**1.6**	**5.4**	**(1.9)**	**2.5**	**2.4**	
Non-voice (Rs mn)	**7,631**	**7,905**	**8,740**	**9,546**	**9,881**	**10,779**	**12,131**	**13,704**	**8.7**
Growth qoq (%)	**(0.2)**	**3.6**	**10.6**	**9.2**	**3.5**	**9.1**	**12.5**	**13.0**	
Total minutes (mn)	140,713	143,680	153,241	172,797	190,396	190,767	199,146	211,822	
RPM (Rs/min)	0.582	0.561	0.517	0.470	0.448	0.444	0.442	0.431	(4.2)
Voice RPM (Rs/min)	0.528	0.506	0.460	0.415	0.396	0.388	0.381	0.367	(5.1)
Change qoq (%)	(7.5)	(4.2)	(9.0)	(9.9)	(4.4)	(2.1)	(1.8)	(3.8)	
Non-voice RPM (Rs/min)	0.054	0.055	0.057	0.055	0.052	0.057	0.061	0.065	2.6
Change qoq (%)	(7.3)	1.5	3.7	(3.1)	(6.1)	8.9	7.8	6.2	

Source: Company, Kotak Institutional Equities

The market growth challenge

We now look at the revenue growth upside potential from a data usage uptick in India. Pure data revenues (non-SMS, non-ring tone, non-IVR) contributes to only about 2.5-3% of India's current wireless revenues base of US$27 bn per annum, in our view – a US$700-800 mn market. Data usage uptick will happen at two levels.

- Small-screen – smartphones and feature phones. Even assuming a 3G small-screen subs base of 120 mn (10% overall pop penetration, ~15% of unique wireless subs) and an incremental ARPU of US$3 per month per 3G sub in 5 years, incremental revenues for the industry work out to a little over US$4.3 bn. We believe that our 120 mn 3G subs base assumption is reasonable and the ARPU assumption of US$3 may be on the aggressive side. The top-173 cities in India have a total population of 215 mn. Hence, a 120 mn 3G subs base can be seen as a ~55% penetration in the top-173 cities or a 35% penetration in top-173 cities + a 5% penetration in the rest of India. Higher penetration is possible but would come at the expense of ARPU and may not change the overall revenue upside, in our view.

- Large-screen – this is a market difficult to forecast, given the very low levels of PC and broadband penetration in India today. India's BB penetration is still ~1% (~12 mn BB subs). Also, unlike the small-screen market which is likely to be dominated by the 3G players, the large screen market will have many competing technologies including DSL, cable, fibre, 3G, EVDO, Wimax and LTE. Assuming large screen subs market expands 4X in 5 years to 44 mn subs, with an ARPU of US$12 per month, one is looking at ~US$6.3 bn market, or an incremental US$3.7 bn revenues (over the current base of US$2.6 bn, implying an ARPU of a little less than US$20 per month). Assuming various wireless technologies (3G, EVDO, Wimax, and LTE) capture 75% of the incremental large screen market, one is looking at incremental revenues of US$2.8 bn for the wireless industry.

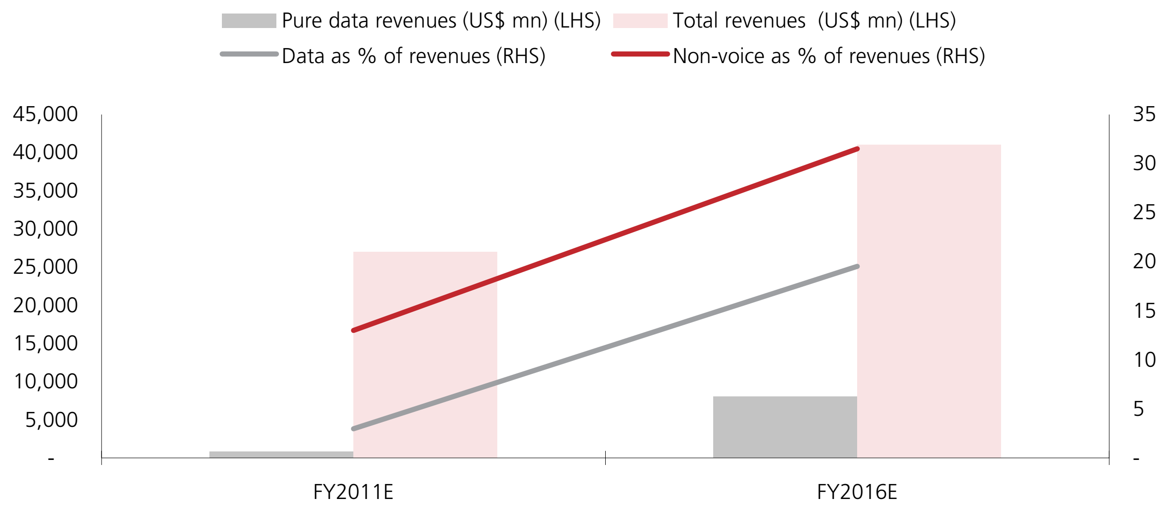
So, there is potentially US$7.1 bn incremental data revenue potential for the wireless industry over the next five years. This would translate into a cumulative growth of 26.3% on the current revenue base of US$27 bn, or a 4.8% kicker to industry 5-year revenue CAGR (see Exhibit 13 below). There is some, though not much, growth left in the industry's voice revenue pie and some kicker is possible from incremental 2G data and VAS usage as well. Nonetheless (1) all put together, wireless industry revenues are unlikely to grow faster than a high single-digit CAGR over the next five years (see Exhibit 14), and (2) there would be new players like Reliance Industries eyeing the data opportunity, especially on the large screen side. Hence, all the growth may not accrue to the current wireless industry players.

Exhibit 13: Rough-cut estimation of growth kicker from hi-speed and BB data for the Indian wireless industry

	Current	In 5 years
Small screen hi-speed internet (smartphones, feature phones)		
# subs (mn) (1)	-	120
Incremental ARPU (US$/sub/month)	NA	3
Market size (US$ bn)	-	4.3
Incremental revenues (A)		**4.3**
Large screen (desktops, laptops, netbooks, tablets)		
# BB subs (mn) (1)	11	44
ARPU (US$/sub/month)	20	12
Market size (US$ bn)	2.6	6.3
Incremental revenues		**3.7**
Of, which - accrual to wireless players (B) (75% of incremental)		**2.8**
Total incremental data revenues for the wireless industry = A + B (US$ bn)	**7.1**	
Current wireless industry size (US$ bn)	27.0	
Cumulative growth in 5 years (%)	**26.3**	
5-year CAGR kicker from hi-speed and BB data for the wireless industry (%)	**4.8**	

Source: Kotak Institutional Equities estimates

Exhibit 14: 10X growth in data = 1.5X growth in overall revenues in 5 years



Source: Kotak Institutional Equities estimates

The data story – there is more to it than just volumes

'Data in India will explode' – agreed, but an investment thesis based on such a statement without asking what 'explosion' pertains to (volumes, revenues, EBITDA, or free cash flow) adds an 'eyeball investing' dimension to it. Yes, India is under-penetrated as far as data or broadband is concerned; yes, 3G rollout makes hi-speed data available to a larger section of the population, and yes, data will grow and grow fast in India. However, it is not a simple 'volume growth = NPV accretion' equation; some other questions are relevant as well – will reach and affordability play a role – essentially, will data growth in India be enough to match Street's optimism without enough reach or at today's prices? – the first one, reach, has capex implications and second one, affordability, has margin implications. The two, together, have free cash flow implications.

Either way, the limited point we wish to make here is to be careful while extrapolating initial 3G numbers being talked about in the market; for two reasons – (1) there is an initial base of subs which would have taken up 3G at any price – the real challenge would be to find the right price/volume equation to convert the next set of subs, and (2) initial capex levels may not reflect true capex intensity of 3G rollouts – as backhaul capex is likely getting pushed back and will follow growth in data volumes – which we agree, will explode, at the right price for the service.

To sum up - value accretion from 3G, in light of the stiff price paid for 3G spectrum, demands what in our view is an 'improbable trinity' – reasonable penetration AT good incremental revenue per user WHILE keeping incremental capex low. Exhibit 15 depicts our analysis. We have essentially tried to assess the subscriber base – incremental ARPU combination required at varying scale of 3G rollout to generate value (ROIC > 12%) from 3G investments.

Exhibit 15: 3G per cell-site economics for a theoretical pan-India operator

Scale	Small	→	→	Medium	→	→	Large
No of cell-sites	**10,000**	**20,000**	**30,000**	**40,000**	**50,000**	**60,000**	**70,000**
Spectrum payment (US$ mn)	3,733	3,733	3,733	3,733	3,733	3,733	3,733
Total Capex (US$ mn)	350	667	950	1,200	1,417	1,600	1,750
Spectrum payment per tower (US$)	373,333	186,667	124,444	93,333	74,667	62,222	53,333
Capex per site (US$)	**35,000**	**33,333**	**31,667**	**30,000**	**28,333**	**26,667**	**25,000**
Total invested capital per tower (US$)	408,333	220,000	156,111	123,333	103,000	88,889	78,333
Target ROIC (%)	**12.0**	**12.0**	**12.0**	**12.0**	**12.0**	**12.0**	**12.0**
Required EBIT*(1-tax rate) (US$)	49,000	26,400	18,733	14,800	12,360	10,667	9,400
Tax rate (%)	**20.0**	**20.0**	**20.0**	**20.0**	**20.0**	**20.0**	**20.0**
Required EBIT (US$)	61,250	33,000	23,417	18,500	15,450	13,333	11,750
Depreciation (US$)	3,500	3,333	3,167	3,000	2,833	2,667	2,500
Amortisation (US$)	18,667	9,333	6,222	4,667	3,733	3,111	2,667
Target EBITDA (US$)	83,417	45,667	32,806	26,167	22,017	19,111	16,917
Incremental steady-state EBITDA margin (%)	**50**	**52**	**53**	**55**	**57**	**58**	**60**
Target incr annual revenues (US$)	166,833	88,387	61,510	47,576	38,853	32,762	28,194
Users per cell-site (#)	**500**	**483**	**467**	**450**	**433**	**417**	**400**
Total 3G users ('000)	**5,000**	**9,667**	**14,000**	**18,000**	**21,667**	**25,000**	**28,000**
ARPU (US$/sub/month)	28	15	11	9	7	7	6
ARPU (Rs/sub/month)	**1,251**	**686**	**494**	**396**	**336**	**295**	**264**
Overall revenues (US$ mn)	**1,668**	**1,768**	**1,845**	**1,903**	**1,943**	**1,966**	**1,974**
Overall EBITDA (US$ mn)	**834**	**913**	**984**	**1,047**	**1,101**	**1,147**	**1,184**

Source: Kotak Institutional Equities estimates

We believe it is important to understand the importance of the low quantity of 3G spectrum (just 5 MHz) that Indian wireless operators have. Most operators around the world have at least 15 MHz and are still struggling to maintain QoS on their data offerings. Data volume explosion has put immense capex pressure on telcos around the world despite their substantially higher spectrum holdings. To cite an example, AT&T, which has close to 35 MHz of 3G spectrum (in addition to some LTE spectrum as well) has had to increase its capex intensity meaningfully over the past 2-3 years to support data volume growth. Not particularly apt in this discussion on capex, but a recent US wireless industry report pegged data volume growth of 120% plus in CY2010 translating into data revenue growth of 20-25% and overall revenue growth in single digits. This brings us back to the initial point we made in this section - **'Data in India will explode' – agreed, but an investment thesis based on such a statement without asking what 'explosion' pertains to (volumes, revenues, EBITDA, or free cash flow) adds an 'eyeball investing' dimension to it.**

Forgetting regulatory risks is risky

As mentioned in our 'willful blindness' section of this note, the Street seems to be comfortable not building in any margin of safety for the potential negatives from regulatory developments. Decision on spectrum pricing remains the biggest one; even as we refrain from hazarding a guess on what the final decision on this aspect will look like, one thing is more likely than not – the cost of spectrum is bound to increase. This increase could impact Bharti in two ways – (1) a potential retrospective payout for excess (over 6.2 MHz) spectrum, and (2) higher spectrum cost on renewals – circle-wise renewals for Bharti start in CY2014. Acceptance of TRAI's spectrum refarming recommendations and any potential further cut in termination charge could add to the negatives.

On the positive side, there could be a potential reduction in license fees (paid as a % of AGR to the Government). However, a recent news report suggests that license fee could be revised to a uniform 8.5% across circle categories versus market's expectation of 6%. This could render it neutral for Bharti.

We summarize all potential negatives and positives (and the per share impact of the same on Bharti) in Exhibit 16 below.

Exhibit 16: Impact of various potential regulatory events on Bharti (Rs/share)

Event	Impact (Rs/share)	
Negatives	Assuming TRAI recos are accepted in totality	Assuming 50% dilution in extent of impact
One time excess spectrum charge	(10)	(5)
Charges on spectrum renewal (NPV of the impact)	(24)	(12)
Spectrum refarming	(37)	(18)
5 paise reduction in termination charges (this is not a part of TRAI recos)	(17)	(9)
Total negatives	**(87)**	**(44)**
Positives		
Reduction in license fees	15	15
Net impact (Rs/share)	**(72)**	**(28)**

Source: Kotak Institutional Equities estimates

Upside case – a lot needs to go right

Right, so we see expectations as lofty, valuations as rich and potential regulatory negatives on the horizon. A case for 'willful blindness' on our part – to changing fundamentals of the industry, data potential, Africa upside – can of course be made. Even as we have discussed in detail the reasoning driving our Cautious view on all of these (and more importantly, all of these, in light of current rich valuations), we look at potential upside sensitivities to our earnings and fair value estimates from various scenarios.

- **Scenario #1 – RPM turns out higher than expectations.** We note a couple of things upfront – (a) this scenario includes the impact of reducing competitive intensity in the market as well as potential data upside – for example, a 2 paise higher RPM than our estimate can be seen as 1 paise coming from competitive pressure easing on the voice side (through consolidation or otherwise – and hence, consolidation scenario is also included here) and the other 1 paise coming from higher-than-expected data upside, and (2) we do not assume any negative impact on volumes despite building in a higher RPM scenario – that is, no negative demand elasticity. Exhibit 17 below gives the upside to our base case revenue, EBITDA, EPS, and fair value estimates at various levels of higher-than-expected RPM. A 1 paise higher-than-expected RPM in the India wireless business has a 6% positive impact on our fair value estimate of Rs345/share (end-FY2013E based).

Exhibit 17: Upside scenario 1: RPM turns out better than expected

	Base case			+0.5 paise			+1 paise			+1.5 paise		
	FY2012E	FY2013E	FY2014E	FY2012E	FY2013E	FY2014E	FY2012E	FY2013E	FY2014E	FY2012E	FY2013E	FY2014E
RPM (Rs/min)	0.421	0.415	0.413	0.426	0.420	0.418	0.431	0.425	0.423	0.436	0.430	0.428
Revenues (Rs bn)	725	827	908	730	832	913	734	837	919	738	842	924
EBITDA (Rs bn)	256	302	334	260	306	339	264	311	344	268	315	349
EBITDA margin (%)	35.4	36.5	36.8	35.7	36.8	37.1	36.0	37.1	37.4	36.3	37.5	37.7
EPS (Rs/share)	19.7	24.5	28.0	20.5	25.3	28.9	21.2	26.1	29.8	22.0	26.9	30.6
Fair value (Rs/share)		**345**			**356**			**365**			**375**	
Change from base case (%)												
RPM				1.2	1.2	1.2	2.4	2.4	2.4	3.6	3.6	3.6
Revenues				0.6	0.6	0.6	1.2	1.2	1.2	1.8	1.8	1.8
EBITDA				1.5	1.5	1.4	3.0	2.9	2.9	4.5	4.4	4.4
EBITDA margin (bps)				31	31	30	63	62	61	95	94	92
EPS				3.7	3.3	3.0	7.5	6.6	6.1	11.3	10.0	9.2
Fair value					**3.1**			**5.8**			**8.6**	

Source: Kotak Institutional Equities estimates

- **Scenario #2 – 3G is more margin-accretive than what we have assumed.** We note that we have built in sustained margin improvement for Bharti's India wireless business from FY2012E onwards. Nonetheless, our assumptions do not build in the sort of incremental margins on 3G revenues (80%) that Bharti management has been indicating – there is scope for positive surprise versus our assumptions here. Exhibit 18 looks at the upside to our estimates if India wireless margins turn out to be better than our current assumptions.

Exhibit 18: Upside scenario 2: 3G leads to an upside in India wireless margins

	Base case			+50bps			+100 bps			+150 bps		
	FY2012E	FY2013E	FY2014E	FY2012E	FY2013E	FY2014E	FY2012E	FY2013E	FY2014E	FY2012E	FY2013E	FY2014E
India wireless margin (%)	34.2	34.4	34.5	34.7	34.9	35.0	35.2	35.4	35.5	35.7	35.9	36.0
Revenues (Rs bn)	725	827	908	725	827	908	725	827	908	725	827	908
EBITDA (Rs bn)	256	302	334	259	304	337	261	307	339	263	309	342
EBITDA margin (%)	35.4	36.5	36.8	35.6	36.8	37.1	35.9	37.1	37.4	36.2	37.4	37.7
EPS (Rs/share)	19.7	24.5	28.0	20.1	24.9	28.5	20.6	25.4	29.0	21.0	25.9	29.5
Fair value (Rs/share)		**345**			**353**			**359**			**365**	
Change from base case (%)												
India wireless margin (bps)				50	50	50	100	100	100	150	150	150
Revenues				-	-	-	-	-	-	-	-	-
EBITDA				0.8	0.8	0.8	1.7	1.6	1.6	2.5	2.4	2.4
EBITDA margin (bps)				29	30	29	59	59	59	88	89	88
EPS				2.1	1.9	1.8	4.2	3.8	3.5	6.3	5.7	5.3
Fair value					**2.2**			**4.0**			**5.8**	

Source: Kotak Institutional Equities estimates

- **Scenario #3 – Africa surprises on the upside.** We try to keep it simple here – we look at various scenarios of Africa EBITDA turning out to be higher than our expectations (while keeping Africa capex the same) – this could be driven by higher-than-expected revenues and/or margins. Exhibit 19 looks at various scenarios.

Exhibit 19: Upside scenario 3: Africa EBITDA higher than estimate

	Base case			+2.5%			+5%			+7.5%		
	FY2012E	FY2013E	FY2014E	FY2012E	FY2013E	FY2014E	FY2012E	FY2013E	FY2014E	FY2012E	FY2013E	FY2014E
Africa EBITDA (Rs bn)	55	71	82	56	73	84	57	74	86	59	76	88
Revenues (Rs bn)	725	827	908	725	827	908	725	827	908	725	827	908
EBITDA (Rs bn)	256	302	334	258	304	336	259	305	338	261	307	340
EBITDA margin (%)	35.4	36.5	36.8	35.5	36.7	37.0	35.7	36.9	37.3	35.9	37.2	37.5
EPS (Rs/share)	19.7	24.5	28.0	20.0	24.8	28.4	20.3	25.2	28.8	20.5	25.5	29.2
Fair value (Rs/share)		**345**			**352**			**358**			**365**	
Change from base case (%)												
Africa EBITDA				2.5	2.5	2.5	5.0	5.0	5.0	7.5	7.5	7.5
Revenues				-	-	-	-	-	-	-	-	-
EBITDA				0.5	0.6	0.6	1.1	1.2	1.2	1.6	1.8	1.8
EBITDA margin (bps)				19	21	23	38	43	45	57	64	68
EPS				1.4	1.4	1.4	2.7	2.7	2.7	4.1	4.1	4.1
Fair value					**2.2**			**3.9**			**5.7**	

Source: Kotak Institutional Equities estimates

- **Scenario #4 – capex intensity turns out to be lower than built into our DCF model.** We note that our capex estimates are higher than consensus expectations. This is based on our belief that capturing 3G/Africa revenue/EBITDA upside without factoring in commensurate capex requirements would be incorrect. Exhibit 20 looks at upside from various scenarios of lower capex.

Exhibit 20: Upside scenario 4: Capex intensity lower than estimate

	Base case			-5%			-10%			-15%		
	FY2012E	FY2013E	FY2014E	FY2012E	FY2013E	FY2014E	FY2012E	FY2013E	FY2014E	FY2012E	FY2013E	FY2014E
Capex (Rs bn)	168	165	162	160	157	154	151	148	146	143	140	137
Revenues (Rs bn)	725	827	908	725	827	908	725	827	908	725	827	908
Capex as % of sales (%)	23	20	18	22	19	17	21	18	16	20	17	15
EBIT (Rs bn)	125	155	173	126	156	175	126	158	177	126	159	179
EBIT margin (%)	17.2	18.8	19.1	17.3	18.9	19.3	17.4	19.1	19.5	17.4	19.2	19.8
EPS (Rs/share)	19.7	24.5	28.0	19.8	24.7	28.4	19.9	25.0	28.8	20.0	25.2	29.2
Fair value (Rs/share)		**345**			**366**			**386**			**405**	
Change from base case (%)												
Capex				(5.0)	(5.0)	(5.0)	(10.0)	(10.0)	(10.0)	(15.0)	(15.0)	(15.0)
Revenues				-	-	-	-	-	-	-	-	-
Capex as % of sales (bps)				(116)	(100)	(89)	(232)	(199)	(178)	(348)	(299)	(267)
EBIT				0.4	0.8	1.2	0.7	1.7	2.5	1.1	2.5	3.7
EBIT margin (bps)				6	16	23	12	32	47	19	48	70
EPS				0.4	1.0	1.4	0.9	2.0	2.8	1.3	3.1	4.3
Fair value					**6.1**			**11.8**			**17.5**	

Source: Kotak Institutional Equities estimates

Final thoughts on valuations

As discussed earlier in the note, we find Bharti's valuations at 8.2X FY2012E EV/EBITDA rich – these are at substantial premium to other EM telcos. In fact, on a proportionate EBITDA basis (adjusted for Bharti's sub-100% ownership in Africa opcos), the FY2012E EV/EBITDA multiple stands even higher at 8.6X. Two arguments that we have heard from the Street supportive of premium multiples for Indian telcos – (1) India is a growth market ('most emerging' of all emerging markets?), and (2) capex intensity in the Indian market is low – advantage of being late in the technology adoption curve.

We have discussed in detail our thoughts on why we believe revenue CAGR in the Indian wireless market is likely to be in the high single-digits at best, over the next five years. Also, low capex intensity argument is futile unless it leads to better-than-global-peers ROCE for the Indian telcos. This is not the case – Bharti's ROCE in the Indian wireless market is not too different from leaders in other markets. This is important as leaders in most markets enjoy a substantial ROCE premium to other players and hence Bharti's high ROCE is not an exception. More importantly, a lot of the lower capex led benefits on 2G have been invested in expensive 3G and BWA spectrum buyouts by the industry. Bharti has also invested a part of this surplus chasing growth in Africa (Zain Africa was an expensive acquisition, in our view). Assuming a return to historical ROCE levels for Bharti is extremely risky, in our view.

We recommend selling Bharti at current levels. Our target price on end-FY2013E stays at Rs345/share. Exhibit 21 gives our DCF for Bharti and Exhibit 22 our implied SOTP valuation.

Exhibit 21: Our end-March 2013E DCF-based price target for Bharti Airtel is Rs345/share
Discounted cash flow value for Bharti Airtel (Rs mn)

	2011	2012E	2013E	2014E	2015E	2016E	2017E	2018E	2019E	2020E	2021E
EBITDA	199,664	256,403	301,922	334,137	361,801	386,995	409,208	429,495	449,141	469,022	487,601
Depreciation	(102,120)	(131,312)	(146,749)	(161,182)	(174,716)	(187,441)	(199,467)	(210,848)	(221,584)	(231,636)	(240,934)
EBIT	97,544	125,091	155,173	172,955	187,086	199,554	209,741	218,647	227,557	237,386	246,666
Capex	(142,190)	(168,284)	(164,883)	(161,743)	(160,002)	(158,420)	(158,690)	(158,228)	(158,415)	(157,129)	(155,671)
Taxes	(17,790)	(25,920)	(37,642)	(46,101)	(53,651)	(61,188)	(69,073)	(77,181)	(85,893)	(92,819)	(99,795)
Change in working capital	97,624	(11,232)	(2,192)	(11,690)	(4,963)	(8,366)	(11,241)	(13,369)	(15,053)	(16,450)	(18,021)
Free cash flow	137,308	50,967	97,204	114,603	143,185	159,022	170,204	180,717	189,780	202,623	214,113
FCF growth (%)		(62.9)	90.7	17.9	24.9	11.1	7.0	6.2	5.0	6.8	5.7
Discounted FCF		50,967	97,204	101,869	113,134	111,686	106,258	100,285	93,613	88,843	83,449

Terminal growth (%)	4.0	
WACC (%)	12.5	
Exit FCF multiple (X)	12.2	
Exit EBITDA multiple (X)	5.4	
End-FY2013E DCF		
PV of explicit cash flows	896,341	47%
PV of terminal value	1,021,028	53%
EV	1,917,369	
Net debt	601,994	
Equity value	1,315,375	
# of shares outstanding	3,798	
Equity value per share (Rs/share)	**346**	

Key assumptions (%)											
Revenue growth	42.1	22.0	14.0	9.8	7.5	6.0	4.9	4.2	3.8	3.7	3.4
EBITDA growth	19.1	28.4	17.8	10.7	8.3	7.0	5.7	5.0	4.6	4.4	4.0
EBITDA margin	33.6	35.4	36.5	36.8	37.1	37.4	37.7	38.0	38.3	38.5	38.8
Capex/sales	23.9	23.2	19.9	17.8	16.4	15.3	14.6	14.1	13.6	12.9	12.4
Return on avg. capital employed	9.4	8.2	9.6	10.4	11.1	11.8	12.5	13.2	14.1	15.5	17.1

Source: Kotak Institutional Equities estimates

Exhibit 22: Bharti SOTP valuation

India business valuation	FY2013E
Core business (ex-towers, ex-Africa)	
Enterprise value (Rs mn) - end-March	1,159,572
EBITDA (ex-Bharti Infratel) (Rs mn)	185,532
EV/EBITDA (X)	6.25
Towerco valuation	
Blended tower base (86.75% Bharti Infratel + 36.44% Indus)	78,807
EV/tower (US$)	90,000
EV (Rs mn)	319,169
India EV (Rs mn)	**1,478,741**
Net debt (Rs mn) -	104,850
Equity value - India business (Rs mn)	**1,373,891**
Equity value - India business (Rs/share)	**362**
Africa business valuation	
Enterprise value (Rs mn) - end-March	339,666
EBITDA (Rs mn)	56,611
EV/EBITDA (X)	6.00
Net debt - (including acquisition debt) (Rs mn)	405,081
Equity value - Africa (Rs mn)	**(65,415)**
Equity value - Africa (Rs/share)	**(17)**
Total equity value = a + b (Rs/share)	**345**

Source: Kotak Institutional Equities estimates

Exhibit 23: Bharti - condensed financials, IFRS, March fiscal year-ends (Rs mn)

	2010	2011	2012E	2013E	2014E	2015E	2016E	2017E
Profit and loss statement								
Revenues	418,472	594,672	725,318	826,822	907,672	975,332	1,033,979	1,084,338
EBITDA	167,633	199,664	256,403	301,922	334,137	361,801	386,995	409,208
EBIT	104,798	97,544	125,091	155,173	172,955	187,086	199,554	209,741
PBT	105,136	76,858	99,692	134,437	158,970	178,837	197,379	215,852
Recurring PAT	89,765	60,469	74,938	92,979	106,509	118,032	128,416	138,584
Recurring EPS (Rs/share)	**23.6**	**15.9**	**19.7**	**24.5**	**28.0**	**31.1**	**33.8**	**36.5**
Balance sheet								
Total Equity	447,225	516,231	590,003	686,798	787,206	898,583	1,019,751	1,150,317
Borrowings	101,898	616,708	596,708	546,708	451,708	363,981	313,981	263,981
Other liabilities	161,817	332,125	343,237	358,692	361,963	370,296	374,133	374,046
Total equity and liabilities	**710,940**	**1,465,064**	**1,529,949**	**1,592,198**	**1,600,877**	**1,632,860**	**1,707,865**	**1,788,344**
Net fixed assets	482,629	651,426	709,782	749,301	771,247	777,918	770,281	750,889
Net intangibles	59,890	637,317	615,932	594,548	573,163	551,779	530,394	509,010
Cash and equivalents	25,323	9,575	15,144	41,612	34,769	68,169	159,992	270,094
Other assets	143,098	166,746	189,090	206,738	221,698	234,994	247,197	258,351
Total assets	**710,940**	**1,465,064**	**1,529,949**	**1,592,198**	**1,600,877**	**1,632,860**	**1,707,865**	**1,788,344**
Cash flow statement								
Operating cash flow		283,455	219,251	262,087	276,346	303,187	317,442	328,894
Capex		(142,190)	(168,284)	(164,883)	(161,743)	(160,002)	(158,420)	(158,690)
Free cash flow		**141,264**	**50,967**	**97,204**	**114,603**	**143,185**	**159,022**	**170,204**
Acquisitions		(706,154)	—	—	—	—	—	—
Borrowings		514,810	(20,000)	(50,000)	(95,000)	(87,727)	(50,000)	(50,000)
Others		34,332	(25,398)	(20,736)	(26,446)	(22,058)	(17,199)	(10,102)
Total change in cash balances		**(15,748)**	**5,569**	**26,468**	**(6,843)**	**33,400**	**91,823**	**110,102**

Source: Kotak Institutional Equities estimates

Exhibit 24: Bharti - segmental financials, IFRS, March fiscal year-ends (Rs mn)

	2010	2011	2012E	2013E	2014E	2015E	2016E	2017E
Revenues								
Wireless - India and South Asia	331,275	362,689	426,016	489,908	532,128	563,957	588,426	606,559
Telemedia services	34,154	36,324	38,076	39,804	41,274	42,493	43,468	44,206
Enterprise	44,798	41,292	43,357	47,692	52,461	57,708	63,478	69,826
Passive Infra	70,852	85,555	98,345	110,164	119,098	125,348	130,016	133,885
Others	5,825	10,317	15,991	19,190	22,068	24,275	26,217	28,052
Wireless - Africa	—	130,651	188,627	217,067	247,130	275,975	303,679	329,023
Gross revenues	486,904	666,828	810,411	923,824	1,014,159	1,089,757	1,155,284	1,211,551
Intersegment eliminations	(68,432)	(72,156)	(85,093)	(97,001)	(106,487)	(114,424)	(121,305)	(127,213)
Net revenues	**418,472**	**594,672**	**725,318**	**826,822**	**907,672**	**975,332**	**1,033,979**	**1,084,338**
EBITDA								
Wireless - India and South Asia	128,053	125,983	145,840	168,437	183,406	195,868	207,045	216,188
Telemedia services	14,729	16,330	17,117	17,894	18,555	19,103	19,542	19,874
Enterprise	12,578	9,947	10,839	11,828	12,906	14,081	15,362	16,758
Passive Infra	24,523	31,737	39,945	45,627	50,010	53,209	55,333	57,046
Others	(9,754)	(10,316)	(5,700)	(5,400)	(5,100)	(4,800)	(4,500)	(4,200)
Wireless - Africa	-	31,359	54,702	70,764	82,294	92,866	103,251	113,019
Intersegment eliminations	(2,496)	(5,376)	(6,340)	(7,227)	(7,934)	(8,525)	(9,038)	(9,478)
Total EBITDA	**167,633**	**199,664**	**256,403**	**301,922**	**334,137**	**361,801**	**386,995**	**409,208**
EBITDA margin (%)								
Wireless - India and South Asia	38.7	34.7	34.2	34.4	34.5	34.7	35.2	35.6
Telemedia services	43.1	45.0	45.0	45.0	45.0	45.0	45.0	45.0
Enterprise	28.1	24.1	25.0	24.8	24.6	24.4	24.2	24.0
Passive Infra	34.6	37.1	40.6	41.4	42.0	42.4	42.6	42.6
Others	(167.5)	(100.0)	(35.6)	(28.1)	(23.1)	(19.8)	(17.2)	(15.0)
Wireless - Africa	—	24.0	29.0	32.6	33.3	33.7	34.0	34.4
Total EBITDA margin	**40.1**	**33.6**	**35.4**	**36.5**	**36.8**	**37.1**	**37.4**	**37.7**

Source: Kotak Institutional Equities estimates

Exhibit 25: Bharti - key assumptions driving our model, IFRS, March fiscal year-ends (Rs mn)

	2010	2011E	2012E	2013E	2014E	2015E	2016E	2017E
India wireless								
End-period subs ('000)	127,619	162,203	199,322	229,610	246,583	256,931	263,771	268,640
Total traffic (bn min)	610	792	970	1,128	1,222	1,280	1,320	1,348
RPM (Rs/min)	0.529	0.441	0.421	0.415	0.413	0.415	0.417	0.419
ARPU (Rs/sub/month)	243	201	188	182	177	176	176	177
MOU (Rs/sub/month)	459	456	447	438	428	424	423	422
EBITDA margin (%)	38.7	34.7	34.2	34.4	34.5	34.7	35.2	35.6
Africa wireless								
End-period subs ('000)	36,000	44,206	56,206	67,606	78,406	88,606	98,206	107,206
ARPU (US$/sub/month)	7.7	7.4	6.9	6.6	6.5	6.4	6.3	6.3
MOU (min/sub/month)		96	127	144	153	160	167	174
RPM (US$ cents/min)		7.7	5.4	4.6	4.2	4.0	3.8	3.6
EBITDA margin (%)	29.0	23.8	31.2	34.3	35.6	36.9	38.3	38.7

Source: Kotak Institutional Equities estimates

"I, Rohit Chordia, hereby certify that all of the views expressed in this report accurately reflect my personal views about the subject company or companies and its or their securities. I also certify that no part of my compensation was, is or will be, directly or indirectly, related to the specific recommendations or views expressed in this report."

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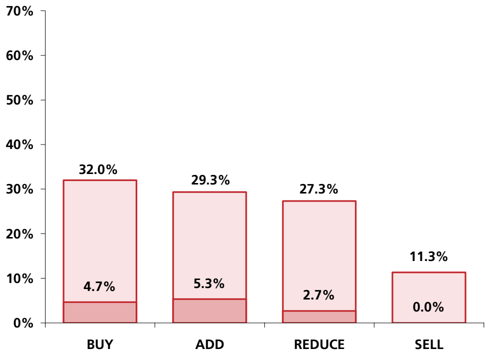

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Source: Kotak Institutional Equities | As of June 30, 2010

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SELL. We expect this stock to underperform the BSE Sensex by more than 10% over the next 12 months.

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