Company Focus

26 January 2009 | 14 pages

Reliance Communications (RLCM.BO)

Downgrade to Sell: B/S normalisation will offset GSM upside

Change in opinion ☑
Rating change ☑
Target price change ☑
Estimate change ☑

- **Downgrade to Sell, TP Rs150** — Our FY10E-11E EBITDA upgrade of 6% is due to an improving revenue market share assumption post-GSM launch. However, we cut EPS by 12-24%, on higher depreciation (capitalisation of CWIP) and interest (excl. forex/treasury gains) and cut our recommendation to Sell (from Hold). Our new Rs150 target price (from Rs270) comprises Rs108 for the core (5.6x FY10E EBITDA, a 30% discount to Bharti) and Rs42 for towerco value.
- **Real debt to manifest in FY10E** — Management clarified that most of the jump in 9mFY09 current liabilities (Rs74bn) was driven by capex payables in addition to the Rs58bn outstanding on March 2008. A large part of this will get converted to debt during the next 12-18 months. In addition, we expect 4QFY09 capex will witness acceleration and forecast net debt to jump from Rs241bn to Rs415bn during FY10, despite lower capex guidance (Rs150bn).
- **GSM changes dynamics, but expect two quarters of KPI volatility** — We upgrade wireless EBITDA by 7-9% for FY10-11E (CAGR of 23% in FY09-11E), giving RCOM benefit of: (i) increasing sub/rev share from GSM, (ii) better MOU elasticity vs. CDMA, and (iii) full year wireless margin of 37.5% (same as 3Q). Inherent in these assumptions is the near-term withdrawal of the trial-period offer, as implied by management. We expect the next two quarter's sub adds / MOU / ARPU will fluctuate widely before falling in-line with broad GSM trends.
- **3Q below par** — EBITDA of Rs23.5bn in 3QFY09 (2% QoQ) was below our expectations. The disappointment was driven by Wireless, where a combination of weak top-line growth (2% QoQ) and initial GSM costs, led to sequential EBITDA decline. Global EBITDA increased but offers little confidence on sustainability.

Sell/High Risk	**3H**
from Hold/High Risk	
Price (23 Jan 09)	Rs160.15
Target price	Rs150.00
from Rs270.00	
Expected share price return	-6.3%
Expected dividend yield	0.6%
Expected total return	**-5.7%**
Market Cap	Rs330,554M
	US$6,736M

Price Performance (RIC: RLCM.BO, BB: RCOM IN)

Statistical Abstract

Year to 31 Mar	Net Profit (RsM)	Diluted EPS (Rs)	EPS growth (%)	P/E (x)	P/B (x)	ROE (%)	Yield (%)
2007A	31,131	15.23	545.7	10.5	1.6	19.4	0.3
2008A	55,097	26.69	75.3	6.0	1.3	23.9	0.5
2009E	59,830	28.99	8.6	5.5	1.1	21.0	0.6
2010E	38,121	18.47	-36.3	8.7	0.9	11.5	0.9
2011E	38,156	18.49	0.1	8.7	0.9	10.4	1.2

Source: Powered by dataCentral

Rahul Singh[1]
+91-22-6631-9863
rahul.r.singh@citi.com

Gaurav Malhotra, CFA[1]
gaurav.a.malhotra@citi.com

Anand Ramachandran, CFA[2]
+852-2501-2448
anand.ramachandran@citi.com

See Appendix A-1 for Analyst Certification and important disclosures.

[1]Citigroup Global Markets India Private Limited; [2]Citigroup Global Markets Asia

Fiscal year end 31-Mar	2007	2008	2009E	2010E	2011E
Valuation Ratios					
P/E adjusted (x)	10.5	6.0	5.5	8.7	8.7
EV/EBITDA adjusted (x)	7.0	5.7	6.2	6.1	5.8
P/BV (x)	1.6	1.3	1.1	0.9	0.9
Dividend yield (%)	0.3	0.5	0.6	0.9	1.2
Per Share Data (Rs)					
EPS adjusted	15.23	26.69	28.99	18.47	18.49
EPS reported	15.23	26.69	28.99	18.47	18.49
BVPS	99.77	124.24	152.10	168.88	185.12
DPS	0.50	0.75	1.00	1.50	2.00
Profit & Loss (RsM)					
Net sales	144,683	190,678	226,577	283,963	332,512
Operating expenses	-112,930	-136,743	-173,698	-225,784	-268,089
EBIT	**31,753**	**53,935**	**52,880**	**58,179**	**64,423**
Net interest expense	-6	3,998	6,500	-18,051	-22,493
Non-operating/exceptionals	0	0	0	0	0
Pre-tax profit	**31,747**	**57,933**	**59,380**	**40,128**	**41,930**
Tax	-616	-2,836	450	-2,006	-3,774
Extraord./Min.Int./Pref.div.	0	0	0	0	0
Reported net income	**31,131**	**55,097**	**59,830**	**38,121**	**38,156**
Adjusted earnings	31,131	55,097	59,830	38,121	38,156
Adjusted EBITDA	56,406	81,989	93,500	116,865	137,983
Growth Rates (%)					
Sales	28.2	31.8	18.8	25.3	17.1
EBIT adjusted	307.1	69.9	-2.0	10.0	10.7
EBITDA adjusted	127.6	45.4	14.0	25.0	18.1
EPS adjusted	545.7	75.3	8.6	-36.3	0.1
Cash Flow (RsM)					
Operating cash flow	**93,037**	**104,625**	**140,204**	**-5,993**	**137,813**
Depreciation/amortization	24,653	28,054	40,620	58,687	73,560
Net working capital	37,247	798	33,044	-120,852	3,604
Investing cash flow	**-59,316**	**-212,034**	**-230,097**	**-146,550**	**-98,119**
Capital expenditure	-59,316	-212,034	-230,097	-146,550	-98,119
Acquisitions/disposals	0	0	0	0	0
Financing cash flow	**80,202**	**86,190**	**-9,031**	**179,749**	**-27,137**
Borrowings	81,407	83,834	0	201,283	0
Dividends paid	-1,196	-1,742	-2,322	-3,483	-4,644
Change in cash	**113,923**	**-21,219**	**-98,924**	**27,206**	**12,558**
Balance Sheet (RsM)					
Total assets	**538,611**	**738,106**	**894,641**	**1,011,653**	**1,048,951**
Cash & cash equivalent	137,200	115,981	17,057	44,263	56,821
Accounts receivable	18,316	27,224	56,644	59,159	55,419
Net fixed assets	330,423	522,153	711,629	799,493	824,051
Total liabilities	**334,624**	**457,368**	**556,395**	**638,769**	**642,554**
Accounts payable	113,092	156,731	260,000	143,000	148,598
Total Debt	174,383	258,217	258,217	459,500	459,500
Shareholders' funds	**203,987**	**280,738**	**338,246**	**372,884**	**406,397**
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	39.0	43.0	41.3	41.2	41.5
ROE adjusted	19.4	23.9	21.0	11.5	10.4
ROIC adjusted	14.0	13.8	9.9	7.8	7.3
Net debt to equity	18.2	50.7	71.3	111.4	99.1
Total debt to capital	46.1	47.9	43.3	55.2	53.1

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Powered by: dataCentral

GSM – Giving RCOM the benefit of the doubt

Our revised assumptions for RCOM's wireless segment, post the GSM launch, capture potential gains from the same, and capture some of the inherent risks for profitability. It is highly likely that the "trial-period offer" will lead to a spurt in sub adds and MOUs, at the cost of rev/min and EBITDA margins over next 1-2 quarters. We do not concentrate our efforts on trying to predict or capture this volatility, but rather on factoring in the potential steady-state gains to RCOM once the "zero-ARPU" offer is withdrawn and the dust settles. Overall, our new assumptions for RCOM post-GSM – in terms of sub market share, higher MOU elasticity, and slightly lower margins – reflect more optimism than caution. Key points on our assumptions are as below.

- Increasing market share of net adds, but slightly below Bharti (BRTI.BO; Rs615.65; 1L), because of the slight coverage gap which will exist vs. its peers. RCOM expects to have a portfolio of 60k towers by the end of FY10, which will be below Bharti's portfolio especially considering the mix of 900/1800Mhz circles.
- Better MoU elasticity vs. CDMA.
- Blended rev/min in-line with Bharti, to give benefit of inbound international roaming and from an upgrade of user profile coming onto the network (primarily from GSM churn). This could prove to be an optimistic assumption, particularly as the existing CDMA users will continue to dominate the user profile at least the next 12-18 months. In addition, we assume that the trial period offer will be discontinued shortly, thus the impact on FY10 estimates is limited.
- Wireless margin assumptions for FY10E/11E have been kept the same as 3QFY09 (~37.7%). The margin assumptions are a function of the revenue/market share gains from GSM, hence they could prove to be optimistic if the GSM revenue uptake is slower than expected.

Figure 1. KPI revision post GSM to align it closer to Bharti

		2010E			2011E	
	Old	New	Bharti	Old	New	Bharti
Sub net adds (m)	1.58	1.95	2.10	1.39	1.75	1.75
MoU (min)	432	440	560	445	450	579
Rev/min (Rs/min)	0.54	0.55	0.55	0.49	0.50	0.50
ARPU (Rs)	234	241	308	217	224	291

Source: Citi Investment Research estimates

As a result of the above assumptions we upgrade Wireless EBITDA by 7% and 9% for 2010E and 2011E respectively, which results in consolidated EBITDA going up by ~6% for both years.

Figure 2. EBITDA upgrade

RsM	2010E			2011E			CAGR FY09E-11E	
	Old	New	Change	Old	New	Change	Old	New
Wireless EBITDA	79,034	84,904	7.4%	93,415	101,630	8.8%	16.0%	23.3%
Consolidated EBITDA	110,169	116,865	6.1%	130,047	137,983	6.1%	16.6%	21.5%

Source: Citi Investment Research estimates

Balance Sheet could unravel in FY10E

The significant ongoing capex on GSM and Global Business (undersea cables) has led to a peculiar situation where a large part of current liabilities are funding the capital work-in-progress. Capitalisation GSM capex will commence in 4QFY09 and continue until end-2009. Meanwhile, the equipment supply payables (included in current liabilities) will get reflected in debt levels over the next 12-18 months. Therefore EBITDA upside from GSM – if and when it happens and assuming RCOM withdraws the free scheme and executes well – could be more than offset by the higher interest charges (from true debt levels) and higher depreciation (from ongoing capitalisation), especially if investors discount the forex/treasury gains being booked in FY09.

The following points on the B/S for 9mFY09 form the basis for our balance sheet projections for FY10E.

1. **Hidden leverage**: Current liabilities increased by Rs74bn during 9mFY09. Management clarified in the earnings call that the increase has predominantly been on account of equipment supply payables for capex. This is in addition to the Rs57.6bn of equipment supply payables embedded in end-FY08 current liabilities. We expect the CL to go up further in 4Q, due to capex acceleration but expect it to normalise FY10 onwards. We expect Net Debt to increase from Rs241bn in end-FY09 to Rs415bn by end-FY10, with Net Debt/EBITDA approaching 3.5x.
2. **Capitalisation**: A large part of the ongoing capex programme – management guidance of Rs250 in FY09 and Rs150bn in FY10 – is still reflected in CWIP i.e. Rs191bn (US$4.0bn) vs. gross block of Rs582bn as at Dec-08. Even though RCOM would start capitalizing GSM capex in 4QFY09, CWIP will remain high in Mar-09 due to the pick-up in capex in last quarter as guided by management. However, we have assumed normalised CWIP in Mar-10 of Rs30bn, assuming full capitalisation of the project capex by then.
3. **Debtors**: In 3QFY09, RCOM witnessed an unusual increase of Rs1,364m in Debtors i.e. almost 70% of the incremental revenues recorded during the quarter.

Figure 3. Balance sheet normalisation post GSM

	Mar-08	Dec-09	Mar-09E	Mar-10E
Assets				
CWIP	149,299	191,602	192,825	30,000
Debtors	27,224	47,441	56,644	59,159
Liabilities				
Current Liabilities	156,213	229,890	260,000	143,000
Net Debt	140,786	229,029	241,160	415,237

Source: Company information and Citi Investment Research estimates

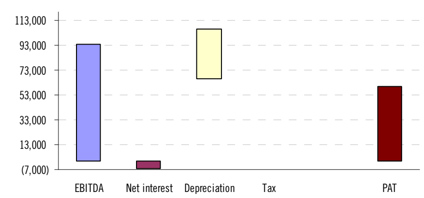
In addition to the high interest and depreciation in FY10E, on account of the above changes, we believe the sustainability of the forex/treasury income is also questionable. While RCOM has booked the gains from rupee depreciation on its forex denominated assets in FY09, the realised/unrealized losses on its forex debt of Rs36bn have been adjusted in the carrying cost of fixed assets. These losses alone account for 78% of the reported 9mFY09 pre-tax profits. The forex/treasury gains will therefore be extremely difficult to achieve given increasing net debt levels on the B/S and assuming the rupee remains stable.

Figure 4. Below EBITDA revisions

RsM	FY2010E			FY2011E		
	Old	New	Change	Old	New	Change
Depreciation	(56,725)	(58,687)	3%	(66,298)	(73,560)	11.0%
Interest expense	(7,571)	(18,051)	138%	(8,430)	(22,493)	166.8%
EPS	21.1	18.5	-12%	24.3	18.5	-24%

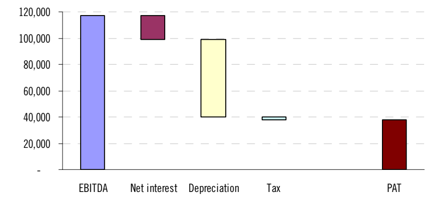
Source: Citi Investment Research estimates

Figure 5. FY09E PAT build-up



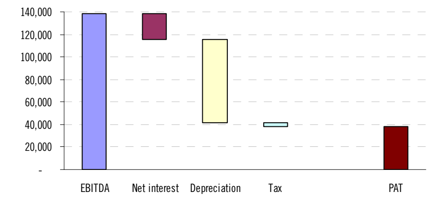
Source: Citi Investment Research estimates

Figure 6. FY10E PAT build-up



Source: Citi Investment Research estimates

Figure 7. FY11E PAT build-up



Source: Citi Investment Research estimates

Downgrade to Sell – New TP at Rs150

Our new target price of Rs150, giving 6% downside from the current market price, is arrived by valuing the core business at Rs108/share and net towerco at Rs42/share. Core business value is based on 5.6x FY0E EV/EBITDA, a 30% discount to Bharti's imputed multiple but in-line with Idea's target multiple.

Our gross value for Reliance Infratel (RTIL) declines to Rs159/share (Rs188 previously), primarily reflecting lower capex/tower which has a direct bearing on the value of towerco. Net towerco value reduces to Rs42/share (Rs55 previously) as a result.

Figure 8. Core Business Value Destruction with Rentals to be Paid to the Towerco

	FY09E	FY10E	FY11E	FY12E	FY13E	FY14E	FY15E	FY16E
RCOM's cost savings via-a-vis base case	-13681	-27472	-34260	-32802	-31836	-31703	-32536	-34070
Potential EBITDA margin impact	-7.9%	-12.1%	-12.7%	-11.4%	-10.3%	-9.2%	-8.3%	-7.5%
Post-tax cash flow	-12997	-24999	-30423	-25257	-23877	-23143	-22450	-22487
NPV (Rs m)	-241550							
NPV (Rs/share)	-117							
Total value creation (Rs/share)	**42**							

Source: Citi Investment Research estimates

Quarterly summary

3QFY09 EBITDA of Rs23.5bn was 4% below our expectations. The disappointment was primarily driven by Wireless with weak top-line growth (2% QoQ growth vs. 13% for Bharti) and margin compression from initial GSM cost. Meanwhile RCOM continues to report slowing net interest income of Rs1,496m in 3QFY09 and Rs6,189m for 9mFY09.

Figure 9. Quarterly Summary

RsM	Sep-07	Dec-07	Mar-08	Jun-08	Sep-08	Dec-08	Q/Q%	Y/Y%
Net Revenues	45,785	48,742	53,114	53,222	56,450	58,502	3.6	20.0
Access and IUC	(6,829)	(7,821)	(6,845)	(6,036)	(5,011)	(5,183)	3.4	(33.7)
Other operating exp	(16,421)	(16,489)	(19,988)	(21,561)	(25,110)	(26,284)	4.7	59.4
License Fees	(2,917)	(3,367)	(3,117)	(3,123)	(3,313)	(3,510)	6.0	4.3
EBITDA	19,618	21,065	23,164	22,502	23,016	23,525	2.2	11.7
PBT	13,989	15,331	15,389	15,564	15,542	14,594	(6.1)	(4.8)
PAT	13,291	13,952	15,661	15,758	16,109	14,441	(10.4)	3.5

Source: Company information and Citi Investment Research

Figure 10. Wireless Summary

RsM	Sep-07	Dec-07	Mar-08	Jun-08	Sep-08	Dec-08	Remarks
Wireless Revenue	37,230	39,567	41,608	41,187	43,356	44,119	Revenue growth lagging peers
Net revenue	27,722	28,892	31,757	31,280	33,626	34,445	
Wireless EBITDA	14,873	15,819	16,763	16,623	16,859	16,616	QoQ decline from a combination of weak top-line growth and startup costs from GSM
Wireless EBITDA margin (%)	39.9	40.0	40.3	40.4	38.9	37.7	GSM costs lead to 120bps margin compression
ARPU	361	339	317	282	271	250	Decline sharper than peers
MoU	490	449	430	424	423	410	Continues to decline, now 7 quarters in a row
Pre-paid as % of net adds	99.2	98.1	98.9	98.7	99.1	99.9	
Non-voice revenue %	6.2	6.4	6.9	7.6	7.3	7.4	
Minutes of usage (bn min)	50.7	52.5	56.5	62.0	67.8	72.1	
Revenue per min (Rs)	0.73	0.75	0.74	0.66	0.64	0.61	Decline in contrast to the increase recorded by peers
EBITDA per min (Rs)	0.29	0.30	0.30	0.27	0.25	0.23	
Capex per min	10.1	33.7	11.6	10.4	5.7	7.6	

Source: Company information and Citi Investment Research

Figure 11. Global Business Summary

RsM	Sep-07	Dec-07	Mar-08	Jun-08	Sep-08	Dec-08	Remarks
NLD mins (m)	5,853	5,795	5,964	6,641	7,856	8,576	Sharp jump in usage
ILD mins (m)	1,688	1,747	1,769	1,726	1,946	1,906	
Global Business Revenue	13,161	13,299	15,257	15,260	16,915	16,783	Decline partially from ADC elimination
Global Business EBITDA	3,276	3,428	4,089	3,222	3,608	4,315	Benefit of rupee + gains from ADC cut
Global Business EBITDA margin (%)	24.9	25.8	26.8	21.1	21.3	25.7	
Net retention per LD min (Rs)	0.45	0.40	0.40	0.40	0.40	0.40	

Source: Company information and Citi Investment Research

Figure 12. Broadband Summary

RsM	Sep-07	Dec-07	Mar-08	Jun-08	Sep-08	Dec-08	Remarks
Broadband revenues	4,371	4,564	5,100	5,603	6,023	6,542	Robust growth continues
Broadband EBITDA	2,102	2,222	2,492	2,714	2,941	2,760	
Broadband EBITDA margin (%)	48.1	48.7	48.9	48.4	48.8	42.2	Sharp contraction in margins
ARPL (Rs)	1948	1797	1760	1715	1668	1681	Focusing on quality of subscribers
Towns active (wireline only)	42	42	42	42	42	42	
Buildings directly connected (nos)	666,368	727,229	787,567	821,638	857,982	892,301	Sustained pace of rollout

Source: Company information and Citi Investment Research

Financial Summary

Figure 13. Profit and Loss Summary

RsM	FY08	FY09E	FY10E	FY11E
Total Revenue	**190,678**	**226,577**	**283,963**	**332,512**
Wireless	152,135	174,112	226,315	270,259
Global Business	54,750	66,106	75,437	84,322
Broadband	17,868	25,019	28,752	30,928
Others	4,304	7,747	11,621	15,107
Eliminations	(38,379)	(46,407)	(58,161)	(68,105)
Total Cost	**(109,008)**	**(133,077)**	**(167,098)**	**(194,529)**
Access & IUC	(28,197)	(49,900)	(64,283)	(77,609)
License Fees	(12,386)	(18,210)	(22,698)	(26,224)
Other Operating Exp	(68,106)	(111,375)	(138,277)	(158,801)
EBITDA	**81,989**	**93,500**	**116,865**	**137,983**
Wireless	60,847	66,862	84,904	101,630
Global Business	14,032	15,609	18,981	21,795
Broadband	8,652	11,416	12,981	14,558
Others	(1,223)	(387)	-	-
Eliminations	(319)	-	-	-
EBITDA Margin (%)	*43.0*	*41.3*	*41.2*	*41.5*
Wireless (%)	*40.0*	*38.4*	*37.5*	*37.6*
Global Business (%)	*25.6*	*23.6*	*25.2*	*25.8*
Broadband (%)	*48.4*	*45.6*	*45.1*	*47.1*
Net Interest	3,998	6,500	(18,051)	(22,493)
Depreciation & Amortisation	(28,054)	(40,620)	(58,687)	(73,560)
PBT	57,933	59,380	40,128	41,930
Tax	(2,836)	450	(2,006)	(3,774)
PAT	**55,097**	**59,830**	**38,121**	**38,156**
EPS	26.7	29.0	18.5	18.5
DPS	0.8	1.0	1.5	2.0

Source: Company information and Citi Investment Research estimates

Figure 14. Balance Sheet

RsM	FY07	FY08	FY09E	FY10E	FY11E
Equity	10,220	10,320	10,320	10,320	10,320
Reserves and Surplus	193,708	246,107	303,615	338,253	371,766
Shareholders funds	203,928	256,427	313,935	348,573	382,086
Debt	**174,383**	**258,217**	**258,217**	**459,500**	**459,500**
Secured Loans	51,136	9,500	9,500	9,500	9,500
Unsecured Loans	123,248	248,717	248,717	450,000	450,000
Current Liabilities	113,092	156,731	260,000	143,000	148,598
Provisions	47,149	42,420	38,178	36,269	34,456
Total Liabilities	**538,611**	**738,106**	**894,641**	**1,011,653**	**1,048,951**
Fixed Assets	**349,456**	**463,640**	**649,238**	**958,613**	**1,056,732**
Accumulated Depreciation	(55,940)	(89,814)	(130,434)	(189,121)	(262,681)
Net Fixed Assets	293,516	373,826	518,804	769,493	794,051
CWIP	36,907	148,327	192,825	30,000	30,000
Investments	11,925	2,797	2,797	2,797	2,797
Cash	137,200	115,981	17,057	44,263	56,821
Current Assets	59,063	97,175	163,158	165,101	165,282
Inventories	4,821	4,059	5,000	5,000	5,000
Debtors	18,316	27,224	56,644	59,159	55,419
Other Current Assets	3,264	23,058	32,281	33,895	35,590
Loans & Advances	32,662	42,834	69,232	67,047	69,273
Total Assets	**538,611**	**738,106**	**894,641**	**1,011,653**	**1,048,951**

Source: Company information and Citi Investment Research estimates

Figure 15. Cash Flow

Rs m	FY09E	FY10E	FY11E
PAT	59,830	38,121	38,156
Add: Depreciation	40,620	58,687	73,560
Change in NWC	33,044	(120,852)	3,604
Add: Interest	6,709	18,051	22,493
Operating Cash Flow	140,204	(5,993)	137,813
Capex	230,097	146,550	98,119
Free Cash Flow	(89,893)	(152,543)	39,695
Cash flow into investments	(230,097)	(146,550)	(98,119)
Increase in debt	-	201,283	-
Increase in Equity	-	-	-
Less: Interest	(6,709)	(18,051)	(22,493)
Less: Dividend	(2,322)	(3,483)	(4,644)
Financial cash flow	(9,031)	179,749	(27,137)
Cash year begin	115,981	17,057	44,263
Cash generated	(98,924)	27,206	12,558
Cash year end	**17,057**	**44,263**	**56,821**

Source: Citi Investment Research estimates

Reliance Communications (RLCM.BO; Rs160.15; 3H)

Company description

RCOM is an integrated player in the Indian telecoms sector. It was listed on the Indian stock exchanges following the de-merger of Reliance Industries. RCOM is the second-largest player in the mobile segment, has an 80,000km-long India-wide optic-fiber network and owns the FLAG submarine cable network. RCOM has three business units: 1) Wireless, which includes a nationwide wireless network on CDMA and GSM; 2) Global Business comprising wholesale voice and data; and 3) Broadband for both retail and enterprise.

Investment strategy

We rate RCOM Sell/High Risk. Though RCOM has been benefiting from the continued wireless growth in India, it has been constrained by the CDMA network in terms of market share and elasticity. The change in consumer mix and market share gains depends on the proposed GSM foray. Though entry into GSM would help RCOM in gaining revenue market share, the gains at the operating level will be offset by the interest and depreciation arising from the significant capex. This could be accentuated by the fact that the capital work-in-progress is being funded by current liabilities presently. Besides, there are inherent risks in the execution of the dual network strategy (i.e. cost duplication, low market share gains) that cannot be wished away. RCOM is investing heavily in the Global Business, the returns for which might be back-ended. The hive-off of towers in a separate company (RTIL) has business potential though with increasing number of operators, and could unlock value in the medium term.

Valuation

Our target price of Rs150 is based on a core business value of Rs108 and net towerco value accretion of Rs42. We usually value Indian wireless plays on DCF given the back-ended nature of profits and cash flow. For RCOM, however, we use EV/EBITDA. The core business value of Rs108 is based on 5.6x FY10E EV/EBITDA, a 30% discount to Bharti's implied target multiple (ex- towerco), the same as employed for Idea’s target price computation. We believe the discount to Bharti is justified on account of the inherent risks of dual network, high hidden leverage, stretched FCF breakeven, and lack of clarity on accounting policies (especially related to finance income).

Risks

Our risk-rating system, which tracks 260-day share price volatility, assigns a High Risk rating to RCOM, which we believe is appropriate given its high hidden leverage in the context to the current credit crunch, prolonged FCF breakeven given high capex plans and a lack of clarity on certain accounting policies. Upside risks to our target price include higher than expected market share gains in GSM and visibility on tenancy of RTIL with possible move towards value monetization. Easing of the macro credit environment and slower conversion of current liabilities to real debt would positively impact the earnings and sentiment on the stock.

Bharti Airtel (BRTI.BO; Rs615.65; 1L)

Company description

Bharti Airtel, through its group companies, provides cellular-phone services in all the 23 telecom circles of India. The group also provides fixed-line phone services, broadband, long-distance and enterprise services. The company is listed on The Stock Exchange, Mumbai (BSE) and The National Stock Exchange of India Limited (NSE). Major shareholders are Bharti Telecom, SingTel and Vodafone.

Investment strategy

We rate Bharti shares Buy / Low Risk (1L). We believe continued robust wireless market expansion in India and Bharti's ability to capture this growth profitably will be a recurring theme. We estimate FY08-11E earnings CAGR of 23.7%, ahead of the broader market. We believe that competitive pressures, though intense, will remain rational as low revenue yields and moderate EBITDA margins leave little room for disruptive pricing. Additionally, most regulatory concerns are behind us and 3G recommendations, though discomforting, cannot derail the growth path, in our view. The company has yet to fully realize benefits of economies of scale, though competitive intensity will prevent and margin gains. We also expect the towerco hive-off (Bharti Infratel) to be a value accretive looking beyond, though a bit back-ended.

Valuation

Our target price of Rs900 is based on Mar-09E core DCF of Rs730 and a towerco option value of Rs170. The DCF is based on a WACC of 12% to reflect current macro environment, a terminal growth rate of 4% and beta of 0.9. We prefer DCF as our primary valuation methodology because the wireless market will likely continue to see robust growth requiring upfront capex but should generate significant free cash beyond FY09-10E. Our target price (standalone ex-towerco) represents a FY10E P/E of 14.2x, P/CEPS of 9.4x and EV/EBITDA of 7.9x.

Risks

Our quantitative risk-rating system, which tracks 260-day share price volatility, rates Bharti shares as Low Risk. We are comfortable attributing a Low Risk rating for the following reasons: 1) Bharti has a track record of profitability and execution; 2) the company's capex plans are fully funded; and 3) SingTel's strategic shareholding leaves us comfortable with execution issues and initiatives. Risks that could prevent the stock from reaching our target price include competition-led tariff pressures, cut in termination fee, un-remunerative capex and excessive bidding for 3G.

Appendix A-1

Analyst Certification

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IMPORTANT DISCLOSURES

Reliance Communications (RLCM.BO)

Ratings and Target Price History
Fundamental Research

Analyst: Rahul Singh
Covered since May 30 2006

	Date	Rating	Target Price	Closing Price
1	29-May-06	*1M	*360.00	276.25
2	12-Oct-06	1M	*430.00	345.95
3	2-Jan-07	1M	*570.00	470.75
4	9-Apr-07	1M	*510.00	415.60
5	20-Jun-07	1M	*600.00	505.90
6	8-Oct-07	*1L	*750.00	640.90
7	6-Nov-07	*2L	*835.00	745.40
8	12-Feb-08	*1L	*760.00	575.70
9	31-Jul-08	*2L	*530.00	500.05
10	2-Nov-08	*2H	*270.00	220.70

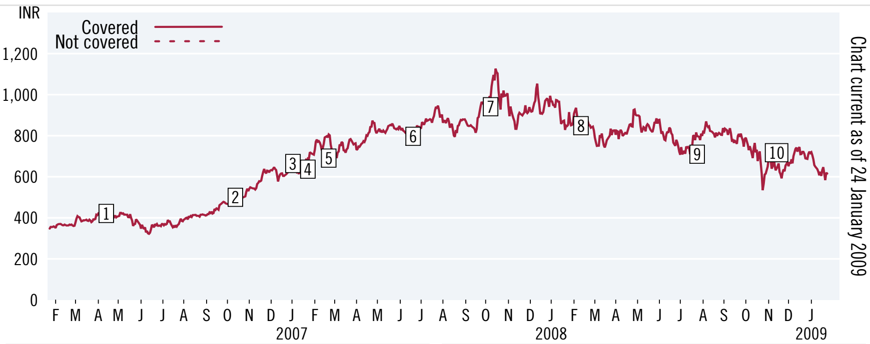
* Indicates change

Rating/target price changes above reflect Eastern Standard Time

Bharti Airtel (BRTI.BO)

Ratings and Target Price History
Fundamental Research

Analyst: Rahul Singh
Covered since April 28 2006



	Date	Rating	Target Price	Closing Price
1	13-Apr-06	1M	*500.00	395.95
2	12-Oct-06	*1L	*600.00	475.65
3	2-Jan-07	1L	*750.00	633.00
4	23-Jan-07	1L	*800.00	689.15
5	21-Feb-07	1L	*960.00	806.30
6	20-Jun-07	1L	*1,050.00	824.65
7	8-Oct-07	1L	*1,200.00	984.80
8	12-Feb-08	1L	*1,150.00	855.80
9	24-Jul-08	1L	*1,070.00	797.95
10	13-Nov-08	1L	*900.00	631.25

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

Rahul Singh, Analyst, holds a long position in the securities of Bharti Airtel.

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% of companies in each rating category that are investment banking clients	48%	43%	38%

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