

Bharti Airtel

| | |
|--------------------|--------------|
| STOCK INFO. | BLOOMBERG |
| BSE SENSEX: 12,907 | BHARTI IN |
| | REUTERS CODE |
| S&P CNX: 3,739 | BRTI.BO |

27 October 2006

Buy

Previous Recommendation: Buy

Rs527

| | |
|-----------------------|---------|
| Equity Shares (m) | 1,895.0 |
| 52-Week Range (Rs) | 530/305 |
| 1,6,12 Rel. Perf. (%) | 6/22/4 |
| M.Cap. (Rs b) | 999.2 |
| M.Cap. (US\$ b) | 22.1 |

| YEAR | NET SALES | PAT | EPS | EPS | P/E | P/BV | ROE | ROCE | EV/ | EV/ |
|-------|-----------|--------|------|------------|------|------|------|------|-------|--------|
| END | (RS M) | (RS M) | (RS) | GROWTH (%) | (X) | (X) | (%) | (%) | SALES | EBITDA |
| 3/06A | 116,631 | 22,584 | 11.9 | 47.4 | 44.2 | 10.9 | 29.5 | 21.6 | 9.0 | 24.0 |
| 3/07E | 184,415 | 38,378 | 20.3 | 69.9 | 26.0 | 7.7 | 34.5 | 27.5 | 5.8 | 14.9 |
| 3/08E | 258,184 | 53,436 | 28.2 | 39.2 | 18.7 | 5.4 | 34.0 | 29.2 | 4.2 | 10.6 |

- **Bharti Airtel' 2QFY07 reported results were better than estimates**, but adjusting for accounting changes results were in line with our estimates. Revenues grew 13% QoQ to Rs43.6b (v/s our estimate: Rs42.7b) and profits grew 23.7% QoQ to Rs9.34b (v/s our estimate: Rs8.77b). EBITDA margins were at 39.1% v/s our estimate of 39%.
- **Mobility revenues grew 16.2% QoQ (ahead of our estimates)**, driven by strong subscriber additions and marginal decline in ARPUs. We are positively surprised by ARPU, which was almost flat on QoQ basis from Rs441 to Rs438. Although average revenue per minute was down marginally by 3%, average MOUs grew 2.2 % QoQ keeping the ARPUs almost flat on a QoQ basis.
- **EBITDA margins for mobility business** improved 50bp QoQ to 36.9% (v/s estimates of 36.6%).
- Long distance revenues grew 18.4% ahead of our expectation, due to robust volume growth, driven by access business. NLD minutes grew 26% QoQ and ILD minutes grew 17% QoQ.
- **Consolidated EBITDA margins expanded 10bp QoQ to 39.1%**, driven by lower access costs and lower network expenses.
- **Interest costs were down 65% QoQ to Rs587m**. The company incurred forex gains of Rs471m during the quarter against losses of Rs967m in 1QFY07.
- **Raising EPS estimates:** We are raising our EPS estimates by 7.7% for FY07 to Rs20.3 and by 9.7% for FY08 to Rs28.2. The stock is trading at P/E of 26x FY07E EPS and 18.7x FY08E EPS. We reiterate **Buy** with a price target of Rs620 at 22x FY08E earnings.

QUARTERLY PERFORMANCE (CONSOLIDATED)

(RS MILLION)

| Y/E MARCH | FY06 | | | | FY07 | | | | FY06 | FY07E |
|-------------------------------|---------------|---------------|---------------|---------------|---------------|---------------|---------------|---------------|----------------|----------------|
| | 1Q | 2Q | 3Q | 4Q | 1Q | 2Q | 3QE | 4QE | | |
| Gross Revenue | 25,172 | 27,090 | 30,256 | 34,113 | 38,564 | 43,572 | 48,953 | 53,326 | 116,631 | 184,415 |
| YoY Growth (%) | 48.6 | 46.3 | 41.9 | 46.7 | 53.2 | 60.8 | 61.8 | 56.3 | 45.7 | 58.1 |
| QoQ Growth (%) | 8.2 | 7.6 | 11.7 | 12.7 | 13.0 | 13.0 | 12.4 | 8.9 | | |
| Access & Interconnect Charges | 4,849 | 4,928 | 5,571 | 6,447 | 6,612 | 7,190 | 8,077 | 9,119 | 21,795 | 30,998 |
| Net Revenue | 20,323 | 22,162 | 24,685 | 27,666 | 31,952 | 36,382 | 40,876 | 44,207 | 94,836 | 153,417 |
| Total Operating Expenses | 10,916 | 11,951 | 13,486 | 14,884 | 16,930 | 19,357 | 21,718 | 23,312 | 51,237 | 81,316 |
| EBITDA | 9,407 | 10,211 | 11,199 | 12,782 | 15,022 | 17,025 | 19,158 | 20,895 | 43,599 | 72,101 |
| Margin (%) | 37.4 | 37.7 | 37.0 | 37.5 | 39.0 | 39.1 | 39.1 | 39.2 | 37.4 | 39.1 |
| Net Finance Costs | 149 | 845 | 924 | 733 | 1,691 | 587 | 1,099 | 1,203 | 2,651 | 4,581 |
| Cash Profit from Operations | 9,258 | 9,366 | 10,275 | 12,049 | 13,331 | 16,438 | 18,059 | 19,692 | 40,948 | 67,520 |
| Depreciation & Amortisation | 3,403 | 3,703 | 4,026 | 4,698 | 4,972 | 5,926 | 6,276 | 6,807 | 15,830 | 23,981 |
| Profit before Tax | 5,980 | 5,795 | 6,386 | 7,413 | 8,600 | 10,782 | 12,033 | 12,985 | 25,574 | 44,400 |
| Income Tax Expense / (Income) | 815 | 514 | 858 | 549 | 952 | 1,378 | 1,624 | 1,753 | 2,736 | 5,707 |
| Net Profit / (Loss) | 5,099 | 5,209 | 5,453 | 6,823 | 7,552 | 9,338 | 10,335 | 11,153 | 22,584 | 38,378 |
| QoQ Growth (%) | 11.1 | 2.2 | 4.7 | 25.1 | 10.7 | 23.7 | 10.7 | 7.9 | | |
| Margin (%) | 20.3 | 19.2 | 18.0 | 20.0 | 19.6 | 21.4 | 21.1 | 20.9 | 19.4 | 20.8 |

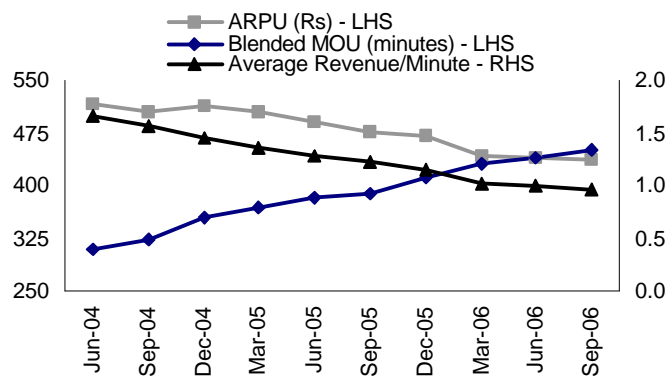
E: MOST Estimates ; Financials as per US GAAP

Robust subscriber growth and flat ARPUs drive Mobility revenues

Bharti reported 16.2% QoQ growth in Mobility revenues for 2QFY07, driven primarily by record subscriber additions. The company added 3.98m subscribers during the quarter, a 17.2% growth in subscriber base for the quarter. ARPUs were flat on a QoQ basis from Rs441 to Rs438. ARPUs were flat due to improvement in minutes of usage. Although average revenue per minute was down marginally by 3%, average MOUs grew 2.2 % QoQ keeping ARPUs almost flat, QoQ. Our conversation with industry indicated increased usage in the B and C circles.

EBITDA margins for mobile business improved 50bp QoQ to 36.9% (v/s estimates of 36.6%). We believe that at lower tariffs MOUs will continue to rise due to elasticity of demand. The company expanded its network to 4,357 census towns and more than 150,000 non-census towns and villages.

TRENDS IN ARPU, MOU AND REVENUE PER MINUTE



Source: Company/ Motilal Oswal Securities

Adjusting for accounting changes, results are in line with our estimates

Bharti made one-time dad debt provision of Rs240m which resulted in lower fixed line margins. Fixed line business margins were at 20.4% v/s our estimate of 24%. Further, there was a reversal of revenue to the tune of Rs292m. Bharti also reclassified customer premise equipment (boosted 2QFY07 profit by Rs581m) and changed its depreciation policy for assets costing less than Rs5,000. Earlier Bharti would amortise the entire amount at the time

of deployment but will now change the methodology to amortise over 12 months from deployment. This also boosted 2QFY07 profits by Rs405m.

If these extraordinary items were to be normalized, adjusted EBITDA of Rs16.75b would be in line with our estimate of Rs16.65b. Assuming the same tax rate as applicable in 2QFY07, extraordinary items had an impact of Rs330m on profit after tax. The adjusted profit after tax of Rs9b is 2.6% higher than our estimate of Rs8.77b.

Aggressive capex surprises but management maintains US\$2b guidance

We were positively surprised by the company's aggressive capex of US\$720m (36% of full year guidance at US\$2b). Management attributed the higher capex to the accelerating momentum in wireless subscriber additions. Further, the company managed to finance aggressive capex largely from working capital reduction and operating cash flows. Debt went up marginally by Rs628m. Net debt/EBITDA improved to 0.8x as of 2QFY07 versus 0.86x as of 1QFY07. Interest costs were down 65% QoQ to Rs587m. The company incurred forex gains of Rs471m during the quarter against losses of Rs967m in 1QFY07.

Robust performance by Long Distance and Enterprise business

Long Distance revenues grew by 18.4% QoQ against our expectation of 2% growth, due to robust volume growth driven by the access business. NLD minutes grew 26% QoQ and ILD minutes grew 17% QoQ. Enterprise business revenues also grew by 9.1% QoQ v/s our estimate of 5%. Bharti is also ramping up its NLD backbone. We think Bharti's Long Distance strategy is tightly woven around its wireless strategy and its expansion of NLD presence is likely to be following up of wireless coverage expansion.

Consolidated EBITDA margins likely to sustain

Overall EBITDA margins expanded 10bp QoQ to 39.1% (v/s our expectation of 39%), driven by margin expansion in the Mobility and Long Distance business. Access and interconnection expenditure, as a percentage of gross

revenue, declined to 16.5% from 17.1%. While mobility margins are likely to expand further, Long Distance margins are likely to remain at the current level of 39%-40%. Fixed line margins which were lower due to reversal of revenue and bad debts provision are likely to bounce back. We expect consolidated margins to remain at current levels driven by mobility margins and improvement in fixed line margins.

Revising forecasts on the back strong subscriber additions and lower ARPU drop

We are revising our forecasts upward to adjust for the stronger growth in the Mobility business and better-than-expected margins. We are revising our subscriber estimates to 1.4m/month for the remainder of FY07 (1.25m earlier) and 1.3m for FY08 (1.25m earlier). We are also reducing our estimate of ARPU decline to 6% for FY07 (10% earlier) and 6% in FY08 (8% earlier). We are raising our EPS

estimates by 7.7% for FY07 to Rs20.3 and by 9.7% for FY08 to Rs28.2.

Valuation and view

Bharti's 2QFY07 overall performance was ahead of our estimates, with the Mobility business reporting higher topline and wireless margins, doing significantly better than our expectations. We were impressed by the company's growth in its mobility business and believe that this business will continue to gain momentum driven by strong subscriber additions. In the long distance segment although margins are likely to be stabilize, volume growth is likely to be robust. We are raising our EPS estimates by 7.7% for FY07 to Rs20.3 and by 9.7% for FY08 to Rs28.2. The stock is trading at P/E of 26x FY07E EPS and 18.7x FY08E EPS. With strong earnings visibility and scope for positive surprises, we reiterate **Buy** with a price target of Rs620 at 22x FY08E earnings.

Bharti Airtel: an investment profile

Company description

Bharti Airtel, promoted by Sunil Bharti Mittal, is the largest cellular services provider in India with a subscriber base of more than 27m and a market share of over 21% of the overall cellular market. It is the first cellular services provider to have introduced the lowest denomination recharge coupon for prepaid subscribers and electronic recharge. It is also the most profitable cellular services provider and is managed by a very strong team of professionals. It is the only player to have a presence in all 23 circles in India.

Key investment arguments

- ☞ Leader in the fast growing Indian cellular market and enjoys scale advantage.
- ☞ Strong innovative management, the biggest differentiator.
- ☞ Most profitable cellular services provider.

Key investment risks

- ☞ Declining ARPM's could lead to lower operating margins.
- ☞ Being a listed company, can not be a price leader due to focus on profitability and hence is reactive to competitor's pricing.

COMPARATIVE VALUATIONS

| | | BHARTI | INFOSYS | TCS |
|---------------|-------|--------|---------|------|
| P/E (x) | FY07E | 26.0 | 30.0 | 25.9 |
| | FY08E | 18.7 | 23.8 | 20.4 |
| P/BV (x) | FY07E | 7.7 | 11.2 | 11.8 |
| | FY08E | 5.4 | 8.2 | 8.1 |
| EV/Sales (x) | FY07E | 5.8 | 5.7 | 5.6 |
| | FY08E | 4.2 | 7.8 | 4.2 |
| EV/EBITDA (x) | FY07E | 14.9 | 24.2 | 20.7 |
| | FY08E | 10.7 | 18.1 | 15.6 |

SHAREHOLDING PATTERN (%)

| | SEP.06 | JUN.06 | SEP.05 |
|---------------|--------|--------|--------|
| Promoter | 45.4 | 45.4 | 45.7 |
| Domestic Inst | 4.0 | 5.0 | 3.2 |
| Foreign | 47.9 | 47.2 | 48.5 |
| Others | 2.7 | 2.4 | 2.6 |

Recent developments

- ☞ Introduced India's first Rs999 Lifetime prepaid card with a lifetime validity on 23 December 2005.
- ☞ Launched Easy Lifetime Prepaid.
- ☞ Launched Airtel Mega its Fixed wireless phone service

Valuation and view

- ☞ Revenue CAGR of 48.7% and earnings CAGR of 53.8% over FY06-08E. Valuations at 26x FY07E earnings and 18.7x FY08E earnings are attractive and at a discount to some similar sized peers in other fast growing industries, like TCS and Infosys.
- ☞ **Buy** with a target price of Rs620, an upside of 17.6% from current levels.

Sector view

- ☞ Rapid growth in mobile subscriber base enabling the cellular market to surpass that of fixed telephony.
- ☞ Industry is forecasting subscriber base would touch 325m by FY10 implying a 38% CAGR over the next 4 years.
- ☞ Tariff cuts to be compensated by volume and cut in regulatory levies, resulting in decent margins and RoE.

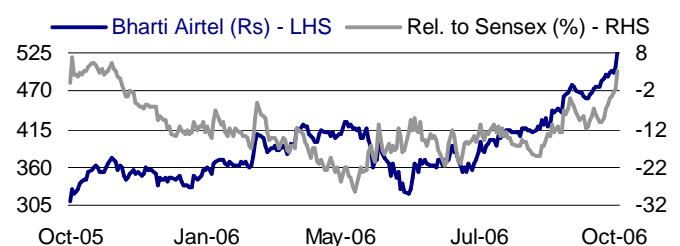
EPS: MOST FORECAST VS CONSENSUS (RS)

| | MOST FORECAST | CONSENSUS FORECAST | VARIATION (%) |
|------|---------------|--------------------|---------------|
| FY07 | 20.3 | 18.6 | 9.1 |
| FY08 | 28.2 | 25.2 | 11.8 |

TARGET PRICE AND RECOMMENDATION

| CURRENT PRICE (RS) | TARGET PRICE (RS) | UPSIDE (%) | RECO. |
|--------------------|-------------------|------------|-------|
| 527 | 620 | 17.6 | Buy |

STOCK PERFORMANCE (1 YEAR)



For more copies or other information, contact

Institutional: Navin Agarwal. **Retail:** Manish Shah, Mihir Kothari

Phone: (91-22) 39825500 Fax: (91-22) 22885038. E-mail: inquire@motilaloswal.com

Motilal Oswal Securities Ltd, 3rd Floor, Hoechst House, Nariman Point, Mumbai 400 021

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Disclosure of Interest Statement

Bharti Airtel

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|---|-----|
| 1. Analyst ownership of the stock | No |
| 2. Group/Directors ownership of the stock | Yes |
| 3. Broking relationship with company covered | No |
| 4. Investment Banking relationship with company covered | No |

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