

Equities

17 March 2011 | 15 pages

Reliance Communications (RLCM.BO)

Upgrade to Buy: Good Asset Now Available at a Discount

- Company Update
- Rating Change
- Target Price Change
- Estimate Change

- **Upgrade to Buy (from Sell)** — RCOM stock has fallen sharply in the last 1 month on newsflow around the 2G spectrum controversy. However at current levels, the stock trades at a 12% discount to Bharti, below its replacement cost and in our view factors in most of these concerns. Besides we have also built in part of the extra spectrum payment which the company may be required to pay and revised risk rating to High (Medium) to account for the business/leverage risks.
- **Lowering target price to Rs127 (from Rs155)** — Our RCOM TP comprises core business at Rs110, based on 6.3x FY12E EV/EBITDA which is at a 25% discount to Bharti and net towerco value accretion of Rs25/share. RCOM's FY11-13E EBITDA is down 5-7% on overall weak business momentum which gets reflected in the decline in core business value. We reduce Rs8/share from the on cash outgo based on a 50% probability of the Government charging the "market" value for the GSM spectrum allotted in 2008 for Rs16.5bn (market value estimated at ~Rs49bn for 4.4MHz based on 3G spectrum thrice as efficient as 2G).
- **Attractive assets available below replacement cost** — RCOM's asset basket consisting of CDMA/GSM/3G spectrum, fiber network and tower portfolio is geared towards mobile data growth. We estimate RCOM's replacement cost at Rs120/share. The stock is currently trading below this making it an attractive acquisition candidate, in our view.
- **Re-rating contingent upon business momentum and leverage** — The company has been experiencing lackluster business momentum with low utilisation of its GSM network vs. its larger peers, besides hurting from MNP in both of its networks. We believe kick starting of the business momentum (minutes growth) and any steps towards de-leveraging (gives company breathing space) will be critical for a sustained re-rating.

Buy/High Risk	1H
<i>from Sell/Medium Risk</i>	
Price (15 Mar 11)	Rs98.00
Target price	Rs127.00
<i>from Rs155.00</i>	
Expected share price return	29.6%
Expected dividend yield	1.5%
Expected total return	31.1%
Market Cap	Rs202,275M
	US\$4,478M

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



Statistical Abstract

Year to	Net Profit	Diluted EPS	EPS growth	P/E	P/B	ROE	Yield
31 Mar	(RsM)	(Rs)	(%)	(x)	(x)	(%)	(%)
2009A	61,477	29.79	11.6	3.3	0.5	17.2	1.0
2010A	48,450	23.47	-21.2	4.2	0.5	11.3	1.5
2011E	16,964	8.22	-65.0	11.9	0.5	3.9	2.0
2012E	15,383	7.45	-9.3	13.1	0.4	3.4	2.0
2013E	23,056	11.17	49.9	8.8	0.4	4.9	2.0

Source: Powered by dataCentral

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See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

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Fiscal year end 31-Mar	2009	2010	2011E	2012E	2013E
Valuation Ratios					
P/E adjusted (x)	3.3	4.2	11.9	13.1	8.8
EV/EBITDA adjusted (x)	5.3	6.9	8.0	6.9	5.6
P/BV (x)	0.5	0.5	0.5	0.4	0.4
Dividend yield (%)	1.0	1.5	2.0	2.0	2.0
Per Share Data (Rs)					
EPS adjusted	29.79	23.47	8.22	7.45	11.17
EPS reported	29.79	23.47	8.22	7.45	11.17
BVPS	204.85	210.08	216.05	221.25	230.17
DPS	1.00	1.50	2.00	2.00	2.00
Profit & Loss (RsM)					
Net sales	229,411	222,502	204,576	226,065	249,329
Operating expenses	-175,924	-181,461	-177,744	-195,543	-210,136
EBIT	53,487	41,041	26,832	30,522	39,193
Net interest expense	7,867	11,863	-10,126	-13,042	-11,075
Non-operating/exceptionals	0	0	0	0	0
Pre-tax profit	61,354	52,904	16,706	17,480	28,118
Tax	123	-4,454	258	-2,098	-5,061
Extraord./Min.Int./Pref.div.	0	0	0	0	0
Reported net income	61,477	48,450	16,964	15,383	23,056
Adjusted earnings	61,477	48,450	16,964	15,383	23,056
Adjusted EBITDA	92,875	78,868	67,174	78,118	89,023
Growth Rates (%)					
Sales	20.3	-3.0	-8.1	10.5	10.3
EBIT adjusted	-0.8	-23.3	-34.6	13.8	28.4
EBITDA adjusted	13.3	-15.1	-14.8	16.3	14.0
EPS adjusted	11.6	-21.2	-65.0	-9.3	49.9
Cash Flow (RsM)					
Operating cash flow	18,050	97,977	88,534	91,540	79,031
Depreciation/amortization	39,388	37,827	40,342	47,596	49,830
Net working capital	-74,948	23,563	18,103	15,519	-4,931
Investing cash flow	-255,510	-42,191	-116,018	-27,014	-22,746
Capital expenditure	-255,510	-42,191	-116,018	-27,014	-22,746
Acquisitions/disposals	0	0	0	0	0
Financing cash flow	180,656	-106,186	42,230	-17,686	-15,719
Borrowings	175,111	-114,566	60,000	0	0
Dividends paid	-2,322	-3,483	-4,644	-4,644	-4,644
Change in cash	-56,804	-50,400	14,746	46,840	40,565
Balance Sheet (RsM)					
Total assets	1,022,070	925,686	1,017,565	1,035,325	1,044,175
Cash & cash equivalent	109,724	48,637	65,530	112,370	152,935
Accounts receivable	39,618	33,117	31,255	34,538	38,092
Net fixed assets	727,053	712,539	702,365	686,076	663,284
Total liabilities	592,718	485,496	565,055	572,076	562,514
Accounts payable	118,013	125,476	145,035	152,056	142,494
Total Debt	433,328	318,763	378,763	378,763	378,763
Shareholders' funds	429,352	440,190	452,510	463,249	481,661
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	40.5	35.4	32.8	34.6	35.7
ROE adjusted	17.2	11.3	3.9	3.4	4.9
ROIC adjusted	8.3	4.7	3.5	3.6	4.5
Net debt to equity	75.4	61.4	69.2	57.5	46.9
Total debt to capital	50.2	42.0	45.6	45.0	44.0

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Upgraded to Buy (Sell) with Rs127/share TP

We cut RCOM's FY11-13 EBITDA estimates by 5-7% on overall weak momentum across business segments. The decrease at the EPS level gets accentuated due to higher capitalization charge.

RCOM's core business value of Rs110/share is based on 6.3x FY12E EV/EBITDA, i.e. at a 25% discount to Bharti's imputed multiple on its DCF (domestic business). We believe that discount to Bharti is justified given:

- Inherent risks in dual network and lower capacity utilisation in GSM.
- High leverage (FY11E net debt at Rs313bn) with FY11E net debt/EBITDA at 4.7x leaves RCOM's BS exposed to any adverse regulations (read retrospective 2G spectrum payments).

RCOM's net towerco value based on Mar-11E DCF is at Rs25/share. The value has declined given low visibility on external tenancy especially as Etisalat DB (signed up for bulk tenancy) is currently embroiled in the 2G spectrum controversy and is unlikely to undertake additional Greenfield roll-out. Beside, Etisalat has publicly announced its intention of looking to buy a running business.

The current 2G controversy surrounding the allotment of spectrum at allegedly below market price to the new entrants in 2008 means that there is a risk that the Government could charge market value of 2G spectrum on a retrospective basis. While the probability of this is low, given it would hurt India's "investment climate", assuming a 50% probability of this event, hit on RCOM would be Rs8/share which we include in our TP (based on Rs41bn for 4.4MHz based on 3G spectrum 3x more efficient versus 2G).

RCOM's stock has taken a big hit in the last 1 month, falling 20% on concerns of being embroiled in the 2G spectrum controversy. We believe the stock at current levels provides decent risk adjusted returns. Besides, it currently trades below its replacement value and given its asset portfolio (CDMA, GSM and 3G spectrum, fiber network, towers), geared towards the upcoming data opportunity, is an attractive acquisition candidate, in our view.

Figure 1. RCOM replacement value assumptions

Rs m	Bear case	Comments
Number of towers	50,000	
EV/Tower	3,825,000	US\$85k/tower
Value of towers (191,250	
Active equipment	112,500	50% discount to the Rs3m cost per BTS
Under sea cable (Km)	87,000	
Cost per Km (Rs)	900,000	3x the cost of laying out domestic fiber
Under sea cable	78,300	
Domestic fiber business	190,000	
Cost per km (Rs)	300,000	
Domestic fiber business	57,000	
Others	27,615	Book value
Spectrum		
Value of 3G	64,388	75% of price paid
Value of GSM spectrum	48,987	One third the value of 3G spectrum with 3G thrice as efficient as 2G
Value of CDMA spectrum	11,550	Valued at 70% of the value of Rs16.5bn paid for GSM spectrum in 2008
Total replacement value	591,589	
Net debt + equipment supplies payable	345,991	
Equity value	245,598	
Per share	120	
Current share price	98	
% discount	-19.3%	

Source: Citi Investment Research and Analysis estimates

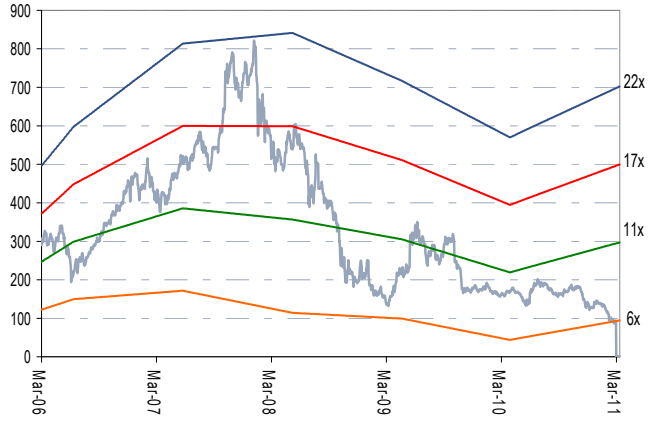
Figure 2. Key revisions

	FY11E			FY12E			FY13E		
	Old	New	% Change	Old	New	% Change	Old	New	% Change
Operating Metrics Revisions									
ARPU (Rs)	122	117	-4.5%	108	105	-3.3%	106	100	-5.8%
Rev/min (Rs)	0.44	0.44	0.0%	0.42	0.42	1.2%	0.41	0.41	1.2%
MOU (mins)	278	265	-4.5%	261	249	-4.5%	262	244	-7.0%
Traffic growth	12.0%	7.0%	-5.0%	15.0%	15.0%	0.0%	15.0%	12.0%	-3.0%
Wireless Margins	29.2%	29.2%	0.0%	30.4%	30.2%	-0.2%	31.6%	31.4%	-0.2%
Earnings Revisions									
EBITDA (Rs m)	70,483	67,174	-4.7%	82,916	78,118	-5.8%	95,879	89,023	-7.2%
EPS (Rs)	7.79	8.22	5.5%	11.13	7.45	-33.0%	15.08	11.17	-25.9%

Source: Company and Citi Investment Research and Analysis estimates

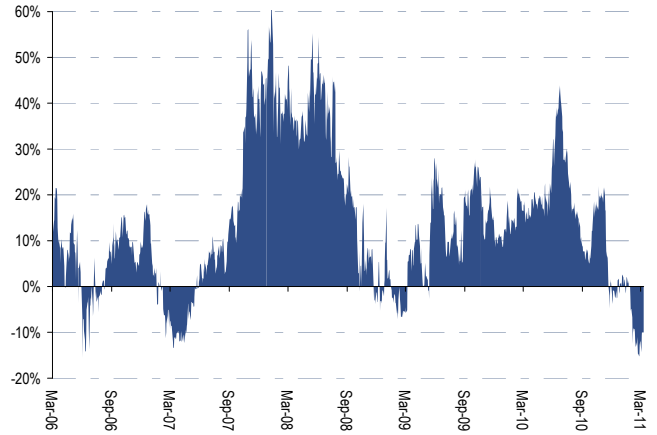
Deep discount to Bharti, trading below replacement value

Figure 3. RCOM EV/EBITDA chart



Source: Citi Investment Research and Analysis

Figure 4. Premium/discount to Bharti



Source: Citi Investment Research and Analysis

Financial summary

Figure 5. RCOM P & L

Year to Mar (Rs m)	FY10	FY11E	FY12E	FY13E
Mobile	169,156	165,040	181,169	198,078
Global Business	81,583	76,496	84,889	93,155
Broadband	28,385	25,896	26,476	27,475
Others	11,796	15,335	19,935	25,916
Eliminations	(68,418)	(78,190)	(86,403)	(95,295)
Total revenues	222,502	204,576	226,065	249,329
Reported EBITDA	78,868	67,174	78,118	89,023
<i>EBITDA margins %</i>	35.4%	32.8%	34.6%	35.7%
<i>Mobile %</i>	33.1%	29.2%	30.2%	31.4%
<i>Global Business %</i>	21.4%	19.3%	20.1%	20.1%
<i>Broadband %</i>	40.4%	37.2%	40.1%	41.1%
<i>Others %</i>	-47.8%	-34.9%	-21.5%	-12.4%
Net Interest	11,863	(10,126)	(13,042)	(11,075)
Depreciation & Amortization	(37,827)	(40,342)	(47,596)	(49,830)
PBT	52,904	16,706	17,480	28,118
Tax	(4,454)	258	(2,098)	(5,061)
PAT	48,450	16,964	15,383	23,056
Number of shares	2,064	2,064	2,064	2,064
EPS	23.5	8.2	7.5	11.2
Key operating data				
	FY10	FY11E	FY12E	FY13E
Total Subs (000)	102,206	132,206	156,206	174,206
Rev/min (Rs)	0.48	0.44	0.42	0.41
MoU (mins)	334	265	249	244
ARPU (Rs)	161	117	105	100
NLD mins (m)	51,283	64,873	76,550	88,033
ILD mins (m)	9,853	14,879	17,110	18,975

Source: Company, Citi Investment Research and Analysis estimates

Figure 6. RCOM Balance Sheet

Rs m	FY10	FY11E	FY12E	FY13E
Equity	10,320	10,320	10,320	10,320
Reserves and Surplus	423,286	435,606	446,345	464,757
Shareholders funds	433,606	445,926	456,665	475,077
Debt	318,763	378,763	378,763	378,763
Current Liabilities	125,476	145,035	152,056	142,494
Minority	6,584	6,584	6,584	6,584
Total Liabilities	924,696	1,016,574	1,034,334	1,043,184
Fixed Assets	786,653	857,617	907,359	948,668
Accumulated Depreciation	(190,671)	(231,013)	(274,317)	(319,855)
Net Fixed Assets	595,982	626,603	633,043	628,813
CWIP	116,557	75,762	53,033	34,472
Goodwill	49,976	49,976	49,976	49,976
Investments	1,147	1,147	1,147	1,147
Deferred tax assets	(991)	(991)	(991)	(991)
Cash and cash equivalents	48,637	65,530	112,370	152,935
Current Assets	113,388	114,844	106,345	101,714
Inventories	5,446	5,000	5,000	5,000
Debtors	33,117	31,255	34,538	38,092
Other Current Assets	20,726	21,763	22,851	23,993
Loans & Advances	54,098	56,827	43,957	34,629
Total Assets	924,696	1,016,574	1,034,334	1,043,184

Source: Company, Citi Investment Research and Analysis estimates

Quants View – Contrarian

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Data as of: 11-Mar-11

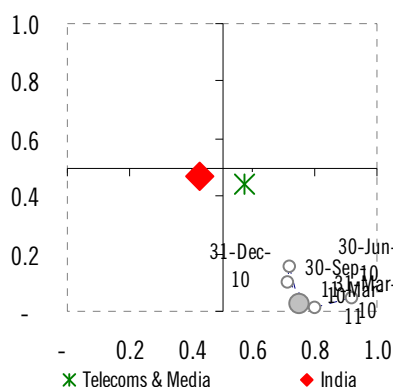
Reliance Communications currently lies in the Extreme corner of the Contrarian quadrant of our Value-Momentum map with relatively weak momentum but strong value scores. Having been a resident there since the past 12 months. Compared to its peers in the Telecoms & Media sector, Reliance Communications fares better on the valuation metric but worse on the momentum metric. Similarly, compared to its peers in its home market of India, Reliance Communications fares better on the valuation metric but worse on the momentum metric.

From a macro perspective, Reliance Communications has a high Beta to the region so is likely to rise (or fall) faster than the region. It is also likely to benefit from falling Commodity (ex-oil) prices, and a weaker US Dollar.

Radar Screen Quadrant Definitions

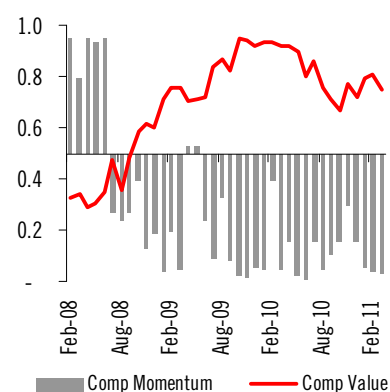
Glamor Poor relative value but superior relative momentum	Attractive Superior relative value and superior relative momentum
Unattractive Poor relative value and poor relative momentum	Contrarian Superior relative value but poor relative momentum

Figure 7. Radar Quadrant Chart History



Source: CIRA

Figure 8. Radar Valuation and Momentum Scores



Source: CIRA

Figure 9. Radar Model Inputs

IBES EPS (Actual and Estimates)			
FY(-2)	26.32	Implied Trend Growth (%)	(31.69)
FY(-1)	28.05	Trailing PE (x)	8.47
FY0	21.62	Implied Cost of Debt (%)	4.47
FY1	7.74	Standardised MCap	(0.03)
FY2	7.55		

Note: Standardised MCap calculated as a Z score – (mkt cap - mean)/std dev – capped at 3

Source: Citi Investment Research and Analysis, Worldscope, I/B/E/S

Figure 10. Stock Performance Sensitivity to Key Macro Factors

Region	1.56	Commodity ex Oil	(0.51)
Local Market	1.33	Rising Oil Prices	0.10
Sector	0.02	Rising Asian IR's	(0.06)
Growth Outperforms Value	(0.37)	Rising EM Yields	(0.19)
Small Caps Outperform Large Caps	0.96	Weaker US\$ (vs Asia)	3.38
Widening US Credit Spreads	(0.21)	Weaker ¥ (vs US\$)	0.03

Source: Citi Investment Research and Analysis

Reliance Communications

Valuation

Our target price of Rs127 comprises (i) core business value of Rs110, based on 6.3x Mar-12E EV/EBITDA, at a 25% discount to Bharti's implied target multiple; plus (ii) towerco value accretion of Rs25 based on long-term external tenancy of 0.5x. We believe a 25% discount to Bharti on the core business valuation is justified on account of the inherent risks of dual network and higher leverage. Our towerco net value accretion of Rs25 is based on the following assumptions: 1) Long-term tenancy of 2.15x with captive tenancy of 1.65x; 2) Capex recovery of 12%, 3) WACC of 11.3% and terminal growth rate of 3%. Note that the incremental value accretion to RCOM is calculated after netting off the contribution from the captive tenancy. Thus, it only reflects the value of the external revenues. We reduce Rs8/share from the on cash outgo based on a 50% probability of the Government charging the "market" value for the GSM spectrum allotted in 2008 for Rs16.5bn (market value estimated at ~Rs49bn for 4.4MHz based on 3G spectrum thrice as efficient as 2G).

Risks

Our risk-rating system, which tracks 260-day share price volatility, assigns a Medium Risk rating to RCOM. We however believe a High Risk is appropriate given lackluster business momentum and possible penalties by the Government on 2G spectrum especially in the context of its high leverage. Key downside risks that could prevent the stock from reaching our target price include: 1) Further deterioration in core business, 2) higher-than expected penalties related to GSM spectrum allotted in 2008 and 3) inability to deleverage through asset sale.

Appendix A-1

Analyst Certification

The research analyst(s) primarily responsible for the preparation and content of this research report are named in bold text in the author block at the front of the product except for those sections where an analyst's name appears in bold alongside content which is attributable to that analyst. Each of these analyst(s) certify, with respect to the section(s) of the report for which they are responsible, that the views expressed therein accurately reflect their personal views about each issuer and security referenced and were prepared in an independent manner, including with respect to Citigroup Global Markets Inc and its affiliates. No part of the research analyst's compensation was, is, or will be, directly or indirectly, related to the specific recommendation(s) or view(s) expressed by that research analyst in this report.

IMPORTANT DISCLOSURES

Reliance Communications (RLCM.BO)

Ratings and Target Price History Fundamental Research

Analyst: Gaurav Malhotra, CFA
Covered since June 18 2010



Chart current as of 12 March 2011

	Date	Rating	Target Price	Closing Price
1	31-Jul-08	*2L	*530.00	500.05
2	2-Nov-08	*2H	*270.00	220.70
3	26-Jan-09	*3H	*150.00	160.15
4	30-Apr-09	3H	*190.00	214.95

	Date	Rating	Target Price	Closing Price
5	28-May-09	3H	*270.00	297.35
6	2-Aug-09	*2M	*310.00	275.65
7	8-Oct-09	*3M	*210.00	246.30
8	12-Dec-09	3M	*160.00	183.65

	Date	Rating	Target Price	Closing Price
9	8-Jul-10	3M	*165.00	187.95
10	22-Nov-10	3M	*155.00	149.30

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

Reliance Communications (RLCM.BO)

Ratings and Target Price History Best Ideas Research Relative Call (3 Month)

Analyst: Gaurav Malhotra, CFA
Covered since June 18 2010

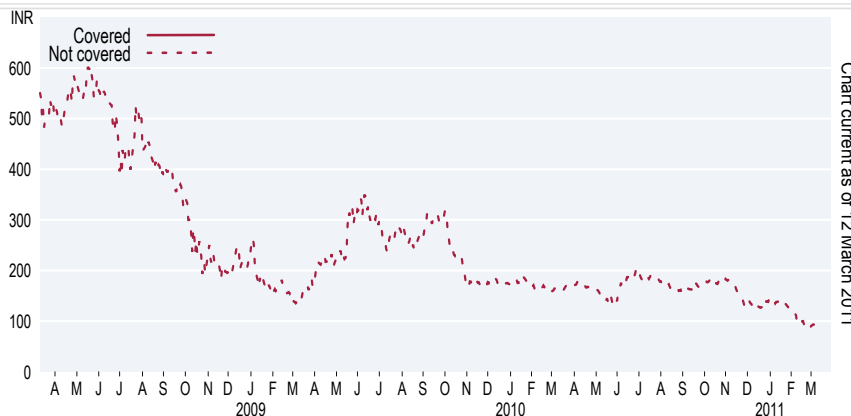


Chart current as of 12 March 2011

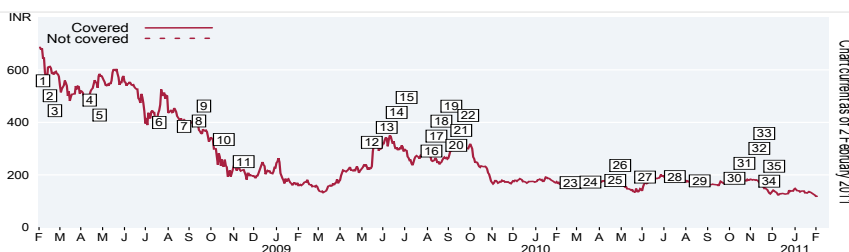
* Indicates change

Rating/target price changes above reflect Eastern Standard Time

Reliance Communications Ltd (RLCM.NS)

Rating History
Global Quantitative Research
Asia Radar Screen

Analyst: Paul R Chanin



Date	Rating	Target Price	Closing Price
1 4-Feb-08	*2	-	686.10
2 18-Feb-08	*1	-	613.05
3 25-Feb-08	*2	-	591.60
4 14-Apr-08	*1	-	493.80
5 28-Apr-08	*2	-	585.05
6 21-Jul-08	*4	-	446.50
7 25-Aug-08	*5	-	410.15
8 15-Sep-08	*3	-	370.05
9 22-Sep-08	*4	-	369.80
10 20-Oct-08	*3	-	231.50
11 17-Nov-08	*4	-	219.60
12 15-May-09	*2	-	232.50

Date	Rating	Target Price	Closing Price
13 5-Jun-09	*3	-	339.55
14 19-Jun-09	*2	-	305.05
15 3-Jul-09	*3	-	292.55
16 7-Aug-09	*2	-	254.80
17 14-Aug-09	*1	-	258.55
18 21-Aug-09	*2	-	248.45
19 4-Sep-09	*4	-	292.05
20 11-Sep-09	*3	-	297.85
21 18-Sep-09	*4	-	306.35
22 29-Sep-09	*3	-	299.80
23 19-Feb-10	*2	-	161.95
24 19-Mar-10	*3	-	167.95

Date	Rating	Target Price	Closing Price
25 23-Apr-10	*1	-	167.50
26 30-Apr-10	*3	-	163.75
27 4-Jun-10	*4	-	168.55
28 16-Jul-10	*3	-	187.25
29 20-Aug-10	*4	-	163.05
30 8-Oct-10	*2	-	180.55
31 22-Oct-10	*4	-	179.15
32 12-Nov-10	*3	-	169.90
33 19-Nov-10	*2	-	148.25
34 26-Nov-10	*3	-	130.50
35 3-Dec-10	*4	-	139.35

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

Reliance Communications Ltd (RLCM.BO)

Rating History
Global Quantitative Research
World Radar Screen

Analyst: Chris Montagu
Covered since May 23 2009



Date	Rating	Target Price	Closing Price
1 7-Feb-08	*6	-	644.05
2 6-Mar-08	*3	-	527.60
3 3-Apr-08	*4	-	513.40
4 14-May-08	*3	-	559.30
5 3-Jul-08	*2	-	389.50
6 3-Aug-08	*3	-	436.80
7 8-Sep-08	*7	-	398.55
8 7-Oct-08	*10	-	300.15
9 7-Nov-08	*5	-	228.15
10 4-Dec-08	*3	-	196.95

Date	Rating	Target Price	Closing Price
11 4-Mar-09	*8	-	137.85
12 14-May-09	*4	-	224.65
13 8-Jun-09	*2	-	309.45
14 7-Jul-09	*5	-	264.75
15 10-Aug-09	*2	-	252.30
16 14-Sep-09	*6	-	292.45
17 8-Oct-09	*7	-	246.30
18 9-Nov-09	*3	-	174.10
19 7-Dec-09	*6	-	175.90
20 1-Feb-10	*7	-	173.80

Date	Rating	Target Price	Closing Price
21 1-Mar-10	*4	-	157.35
22 1-Apr-10	*7	-	170.95
23 1-May-10	*4	-	163.65
24 1-Jun-10	*7	-	139.25
25 1-Jul-10	*8	-	192.30
26 1-Aug-10	*7	-	178.45
27 1-Sep-10	*9	-	163.70
28 1-Nov-10	*8	-	183.55
29 1-Dec-10	*7	-	137.25
30 1-Jan-11	*8	-	145.10

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

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Data current as of 31 Dec 2010

	12 Month Rating			Relative Rating		
	Buy	Hold	Sell	Buy	Hold	Sell
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% of companies in each rating category that are investment banking clients	45%	44%	40%	0%	44%	0%
Citi Investment Research & Analysis Quantitative World Radar Screen Model Coverage	30%	40%	30%			
% of companies in each rating category that are investment banking clients	24%	23%	19%			
Citi Investment Research & Analysis Quantitative Decision Tree Model Coverage	45%	0%	55%			
% of companies in each rating category that are investment banking clients	55%	0%	50%			
Citi Investment Research & Analysis Asia Quantitative Radar Screen Model Coverage	20%	60%	20%			
% of companies in each rating category that are investment banking clients	23%	20%	20%			
Citi Investment Research & Analysis Australia Radar Model Coverage	51%	0%	49%			
% of companies in each rating category that are investment banking clients	30%	0%	15%			

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