Company report

Telecoms, Media & Technology
Diversified Telecoms
Equity – India

HSBC Global Research

Reliance Communication

Neutral (V)

Target price (INR)	180.00
Share price (INR)	136.90
Potential total return (%)	31.5

Mar	2008a	2009e	2010e
HSBC EPS	20.18	28.04	21.90
HSBC PE	6.8	4.9	6.3

Performance	1M	3M	12M
Absolute (%)	-16.0	-30.5	-73.4
Relative^ (%)	-8.5	-24.1	-48.5

Note: (V) = volatile (please see disclosure appendix)

9 March 2009

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Remain N(V): No quick way to get GSM to scale

- **We present bull (INR223-261) and bear (INR101-123) ranges for RCOM after its sharp fall (43%YTD)**
- **External tenancy drives tower business; tenancy from new players provides limited upside of INR30 per share**
- **Retain TP of INR180; underinvestment in networks key to our sceptical view on GSM strategy**

RCOM has underperformed (down 43% YTD) the Indian telcos and Sensex (down 15% YTD) – In an attempt to determine if the worst has been priced into the stock we have derived bull and bear case ranges. Our analysis provides a bull case range of INR223-261 and bear case range of INR101-123. We identify investments in networks and competitive intensity as the key criteria for deriving a bull and bear case. Our estimate of a 22% decline in FY10 earnings, plus the 74% decline in share price over the last 12 months, suggests that RCOM has suffered a structural derating. We see no quick and easy catalyst to get the GSM business to scale and profitability, suggesting that the likelihood of a bull case is muted.

Receipt of additional spectrum on the back of ramp-up in subscribers is unlikely to result in improvement in network coverage; however, it would boost network capacity. We highlight that all longer-term structural rerating factors such as ability to penetrate rural India, benefits from MNP, ability to close the revenue market share gap with Bharti, and improvement in realisation rates are related to improvement in network coverage. Recent CDMA tariff plans support our concerns over cannibalisation and also reflect RCOM's shift to a yield-based approach. On the tower business we remain sceptical about new entrants and believe incremental tenancy from new players provides limited upside of INR30 (versus estimated upside of INR50 if external tenancy stems from established players).

Current competitive intensity and regulatory framework prevent Indian wireless space from being defensive despite robust subscriber/revenue growth; we reiterate that price wars suggest near-term share price weakness for Bharti but we like it on a longer-term basis.

We retain our target price of INR180 (base case remains unchanged) – Our fair value for the core business is based on 8.3x FY10e earnings, c30% discount to the HSBC Sensex target of 11.9x, to capture declining earnings growth, accounting issues and execution risks. We view unlocking of non-core assets and lowering of termination charges as near-term upside risks as and higher than anticipated competitive intensity as a key downside risk.

Index^	BOMBAY SE SENSITIVE INDEX
Index level	8,446
RIC	RLCM.NS
Bloomberg	RCOM IN

Source: HSBC

Enterprise value (INRm)	533950
Free float (%)	35
Market cap (USDm)	5,482
Market cap (INRm)	282,565

Source: HSBC

HSBC

Financials & valuation

Financial statements

Year to	03/2008a	03/2009e	03/2010e	03/2011e
Profit & loss summary (INRm)				
Revenue	190,678	227,870	271,850	323,296
EBITDA	81,989	92,138	100,831	114,313
Depreciation & amortisation	-28,054	-39,972	-57,348	-66,942
Operating profit/EBIT	53,935	52,166	43,483	47,372
Net interest	3,997	7,576	6,400	1,442
PBT	70,761	58,097	49,883	48,814
HSBC PBT	57,933	59,742	49,883	48,814
Taxation	-2,836	422	-798	-1,464
Net profit	54,237	55,895	44,951	42,978
HSBC net profit	41,409	57,540	44,951	42,978
Cash flow summary (INRm)				
Cash flow from operations	45,058	57,800	98,400	142,910
Capex	-194,057	-150,125	-115,275	-71,362
Cash flow from investment	-202,744	-194,835	-150,125	-115,275
Dividends	0	0	0	0
Change in net debt	121,201	113,655	51,725	-27,635
FCF equity	-142,293	-76,617	-16,875	71,548
Balance sheet summary (INRm)				
Intangible fixed assets	35,654	35,654	35,654	35,654
Tangible fixed assets	523,126	686,776	779,553	827,886
Current assets	215,813	199,898	206,456	213,773
Cash & others	118,778	65,000	65,000	65,000
Total assets	774,593	922,328	1,021,664	1,077,314
Operating liabilities	156,213	253,405	251,931	287,867
Gross debt	258,217	318,094	369,819	342,184
Net debt	139,439	253,094	304,819	277,184
Shareholders funds	290,263	302,010	346,961	389,939
Invested capital	499,603	603,923	704,733	724,447

Ratio, growth and per share analysis

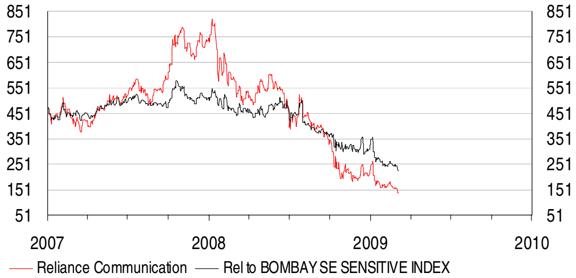
Year to	03/2008a	03/2009e	03/2010e	03/2011e
Y-o-y % change				
Revenue	31.8	19.5	19.3	18.9
EBITDA	43.3	12.4	9.4	13.4
Operating profit	67.2	-3.3	-16.6	8.9
PBT	119.4	-17.9	-14.1	-2.1
HSBC EPS	32.8	39.0	-21.9	-4.4
Ratios (%)				
Revenue/IC (x)	0.5	0.4	0.4	0.5
ROIC	13.6	9.5	6.5	6.4
ROE	16.8	19.4	13.9	11.7
ROA	11.9	7.9	5.7	5.5
EBITDA margin	43.0	40.4	37.1	35.4
Operating profit margin	28.3	22.9	16.0	14.7
EBITDA/net interest (x)				
Net debt/equity	44.3	80.6	84.0	67.6
Net debt/EBITDA (x)	1.7	2.7	3.0	2.4
CF from operations/net debt	32.3	22.8	32.3	51.6
Per share data (INR)				
EPS reported (fully diluted)	26.43	27.24	21.90	20.94
HSBC EPS (fully diluted)	20.18	28.04	21.90	20.94
DPS	0.00	0.00	0.00	0.00
Book value	141.44	147.16	169.07	190.01

Valuation data

Year to	03/2008a	03/2009e	03/2010e	03/2011e
EV/sales	2.2	2.3	2.2	1.7
EV/EBITDA	5.1	5.8	5.8	4.9
EV/IC	0.8	0.9	0.8	0.8
PE*	6.8	4.9	6.3	6.5
P/Book value	1.0	0.9	0.8	0.7
FCF yield (%)	-50.6	-27.3	-6.0	25.5
Dividend yield (%)	0.0	0.0	0.0	0.0

Note: * = Based on HSBC EPS (fully diluted)

Price relative



Source: HSBC

Note: price at close of 06 Mar 2009

Base case

- Underinvestment in networks key to our sceptical view on GSM strategy
- We remain sceptical about new entrants and believe incremental tenancy from new players provides limited upside of INR30
- Recent products on CDMA highlight a shift toward yield-based approach on CDMA platforms

The base case – valuation and investment thesis

Our base case assumes a sceptical view on the GSM operations, largely driven by underinvestments in networks/inadequate tower deployment plans. RCOM's ability to increase investment and improve GSM coverage is reflection of *defacto* funding constraints. We highlight that RCOM faces longer-term structural limitations of operations in 1800MHz on the back of which it requires additional base stations.

For our base case we value RCOM using PE methodology. We value the core business at 8.3x FY10e EPS of INR21.9 to arrive at a fair value of INR180.

Our multiple reflects a 30% discount to the Sensex target multiple of 11.9x; this sharp discount is an attempt to capture declining earnings growth, accounting issues and execution risks. Furthermore, lack of clarity on accounting aspects is a matter of concern for investors and warrants a higher discount to the market. We argue that delayed unlocking of tower and fibre assets, a stretched balance sheet and higher execution risks justify the sharp discount.

The historical premium to the Sensex reflected the company's ability to benefit from monetisation of non-core assets.

Base case assumptions

- Blended mobile ARPU for FY10 is assumed to be INR224.
- We model FY10 EBITDA margins at c31% for the mobile business and c37% for the consolidated business.
- Consolidated business revenues for FY10 are estimated to grow 15% y-o-y.
- CDMA and GSM ARPUs for FY10 are estimated at INR245 and INR151, respectively.
- FY10 EBITDA margins for global business and broadband business estimated at c25% and c33%, respectively.
- We model GSM and CDMA separately. We assume FY10 GSM EBITDA margins at c18% and CDMA c34%.

Change in price over 12, 6, and 3 months and YTD

Operators	12 Months	6 Months	3 Months	YTD
RCOM	-74%	-66%	-26%	-43%
Bharti	-24%	-28%	-9%	-16%
Idea	-56%	-46%	-3%	-16%
Sensex	-49%	-44%	-4%	-15%

Source: HSBC

Base case GSM ARPU; requires rates to move up

Our GSM ARPU assumption of INR150 is based on our view that RCOM will not be able to attract higher end subscribers from the competition due to its underinvestment in the network and will be able to capture only the marginal subscribers.

Idea Cellular was clocking marginal subscriber ARPU of INR230 over the past few quarters from new markets before RCOM entered, when rates on local calls were INR1 per minute and long distance calls were INR1.5 per minute, implying blended outgoing rates of INR1.07 per minute and marginal subscriber MOU of 214.

If we were to build in ARPU estimates for RCOM along similar lines and assume marginal subscriber MOU of 214 on current rates (local calls INR0.5 per minute and long distance calls INR1 per minute, implying effective O/G rate of INR0.56), we arrive at ARPU of INR120. This suggests that RCOM will have to move to profitable plans and raise its realised rates by c20-25% over the next few quarters to meet our base case ARPU assumption of INR150. Another way this could be achieved would be to tap high end subscribers with higher usage, which in our view will be driven by improvement in network coverage and investments in the network. Inability to achieve either will result in lower than modelled ARPU and we would view this as a downside risk to our valuation.

Losing RMS in established markets with dual network presence

Our analysis suggests that RCOM has been losing revenue market share in almost all markets except HP. Our analysis suggests Bharti on the other hand has been gaining share in these markets. Given this we highlight that investors should not get overly excited about longer-term positives on the back of the GSM foray, and factor in possible execution risks.

CDMA strategy

We have highlighted that the combination of lower tariffs and free minute tariff plans on the GSM platform would result in rapid cannibalisation of CDMA (appetite for CDMA products in a GSM centric market was driven by free minutes and cheap on-net calling plans). Our view is supported by recent tariff plans in CDMA, in particular the long distance packs. RCOM recently introduced a new scheme for CDMA subscribers: for INR2,222 recharge subscribers will be offered 500 minutes of free STD/local talk time for 12 months and for INR4,444, 500 minutes of STD will be offered per month for life.

We view the shift toward cheaper plans on CDMA as an attempt to maximise yield on CDMA assets (CDMA is spectrally efficient and allows for a lot of voice capacity). We believe CDMA in India faces an uncertain outlook and with subscriber additions of RCOM moving to GSM, scale economies on CDMA will suffer and will have a negative bearing on CDMA EBITDA margins. CDMA vendors could exit the space, reducing the range and general competitiveness of CDMA products (versus GSM).

With a clear policy on the MVNO issue, we do not rule out the possibility of RCOM exploring MVNO options in an attempt to maximize excess capacity on CDMA.

Tower business

We have not assigned any value to the tower business, as we take a cautious approach in valuing it given the absence of external tenants.

While factors such as the global liquidity crunch, sharp rise in the cost of capital, stretched balance sheet of some existing players and spectrum allocation to new players are positive for the overall tower industry, from a longer-term perspective what really matters is ramp-up in external tenancy. Ramp-up by new entrants is unlikely to result in longer-term positives as new entrants face unviable business models.

Moreover, anchor tenancy requirements are higher for RCOM, given that it needs to operate both GSM and CDMA on its current tower portfolio. In addition, while 3G may have been delayed, it is not ruled out in the foreseeable future, implying that RCOM will have to reserve slots for its 3G needs before it goes to tap new players as external tenants.

When using the PE approach, it is difficult to compute the impact of external tenancy. Our DCF valuation suggests an incremental value of INR50 per share is created on the tower assets with an external tenant. However, we estimate ramp-up of external tenancy by new entrants provides upside of only INR30 as new entrants face an unviable business models. We believe cash flow visibility of 12-15 years will only come from tenancy from established players with viable business models.

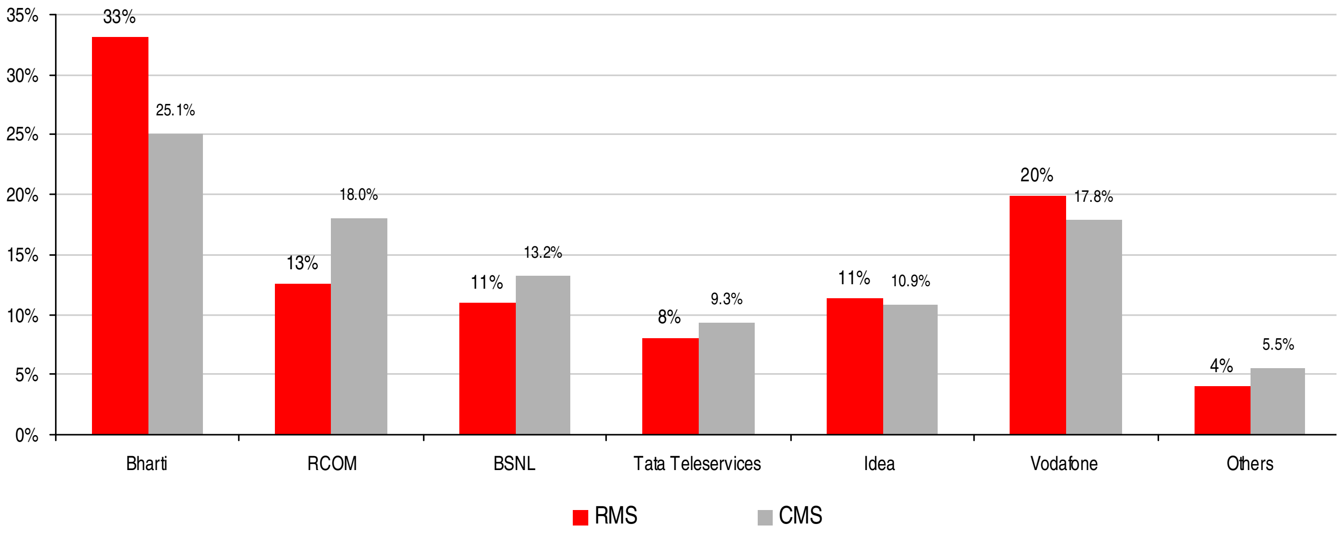
News reports (*Economic Times*) suggest that RCOM could offload a 5% stake and has been in discussions with various global strategic investors including American Tower Co and Crown Castle. We are of the view that tower business economies are better in the US than in India and believe strategic investors may not take a stake until ramp-up in external tenancy is witnessed.

Tower business – US tower business economics relatively attractive

Particulars (Figs in USD)	Crown Castle		American Tower		SBA COM		Indus	
	FY10	Fy11	FY10	Fy11	FY10	Fy11	FY10	Fy11
Sales in USD m	1,727	1,851	1,812	1,963	596	651	1,015	1,237
Towers	22,000	22,000	23,000	23,000	6,300	6,300	76,997	81,829
EV in USD m	11,203	11,203	15,393	15,393	4,921	4,921	10,247	10,247
EBITDA in USD m	1,016	1,102	1,263	1,382	363	402	154	326
Revenue per tower per month	6,543	7,013	6,567	7,114	7,879	8,606	1,098	1,260
EV/EBITDA	11.0x	10.2x	12.2x	11.1x	13.5x	12.2x	66.5x	31.4x
EV/Sales	6.5x	6.1x	8.5x	7.8x	8.3x	7.6x	10.1x	8.3x
EBITDA per tower per month	3,850	4,175	4,576	5,007	4,807	5,320	167	332
EV/Tower in USD '000	509	509	669	669	781	781	133	125

Source: Bloomberg (Crown Castle, American Tower, SBA COM), HSBC estimates (Indus)

Operator-wise RMS and CMS



Source: HSBC

Bharti and RCOM RMS in seven RCOM GSM circles

Circles	Jun-07	Sep-07	Dec-07	Mar-08	Jun-08	Sep-08	Dec-08
Madhya Pradesh							
Bharti	28.7%	29.9%	30.1%	28.5%	35.0%	33.2%	32.9%
Reliance (GSM & CDMA)	27.0%	23.7%	25.1%	22.4%	21.8%	22.1%	20.9%
West Bengal							
Bharti	21.5%	23.7%	23.8%	24.8%	26.6%	27.4%	28.0%
Reliance (GSM & CDMA)	17.3%	15.0%	17.5%	15.3%	14.0%	15.7%	13.7%
Assam							
Bharti	33.4%	29.8%	29.6%	31.8%	32.0%	30.8%	35.7%
Reliance (GSM & CDMA)	21.7%	21.7%	22.6%	25.2%	23.8%	20.8%	20.7%
Bihar							
Bharti	45.5%	42.3%	43.3%	43.7%	47.6%	49.9%	50.3%
Reliance (GSM & CDMA)	34.4%	29.8%	31.5%	30.2%	28.1%	27.2%	23.8%
Himachal Pradesh							
Bharti	39.9%	48.8%	45.5%	44.9%	47.6%	47.9%	45.5%
Reliance (GSM & CDMA)	13.1%	17.3%	28.3%	21.5%	23.0%	23.1%	22.9%
North East							
Bharti	27.1%	26.0%	27.9%	31.8%	32.5%	35.6%	36.3%
Reliance (GSM & CDMA)	11.7%	14.5%	15.3%	14.2%	13.5%	13.4%	10.2%
Orissa							
Bharti	37.3%	44.8%	33.2%	33.7%	49.8%	43.3%	40.4%
Reliance (GSM & CDMA)	23.2%	25.2%	23.9%	19.7%	26.4%	22.2%	18.9%
Kolkata							
Bharti	26.6%	29.0%	28.7%	29.5%	29.6%	30.4%	31.2%
Reliance (GSM & CDMA)	23.0%	20.4%	21.7%	20.1%	19.7%	21.1%	17.9%

Source: TRAI, HSBC

Ratios

Operator	Net debt/EBITDA FY09e	FY10e	FY11e	Net debt/Equity FY09e	FY10e	FY11e	EBITDA/Interest FY09e	FY10e	FY11e
RCOM	4.04	4.19	3.77	1.18	1.16	1.05	5.67	7.91	9.77
Bharti	0.53	-0.02	-0.39	0.14	-0.04	-0.15	-15.18	-37.27	-131.00
Idea	1.20	2.32	1.88	0.24	0.55	0.59	-5.61	-7.78	-4.91

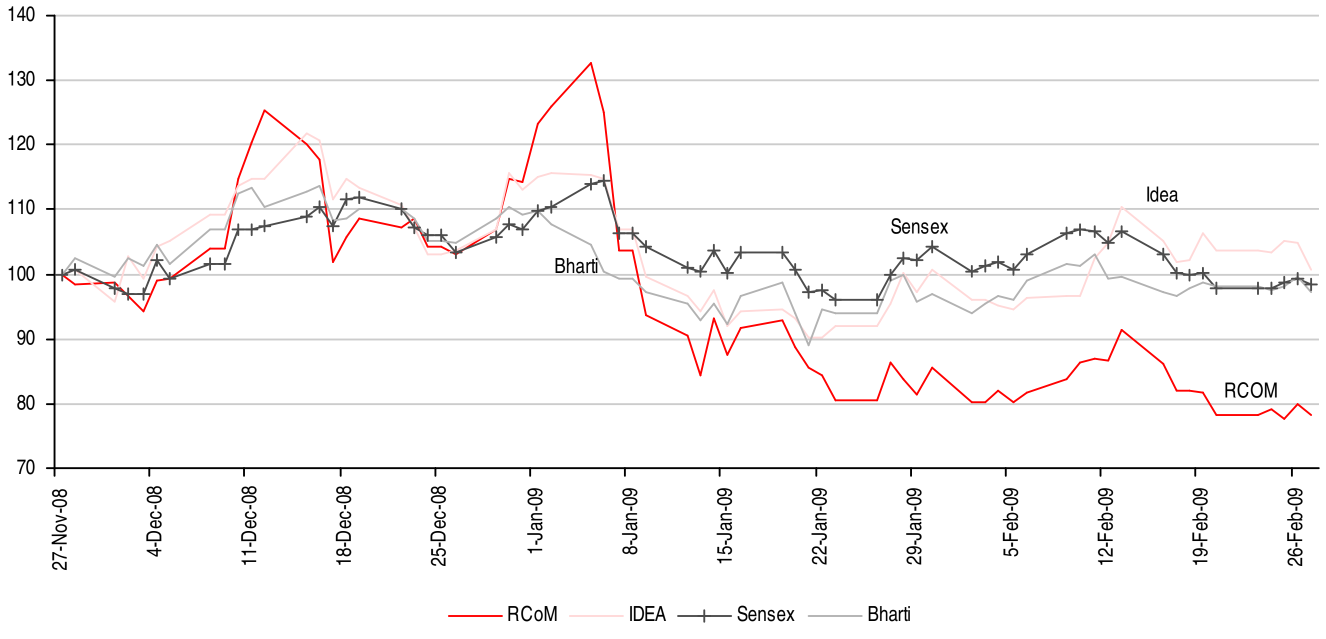
Source: HSBC estimates

HSBC vs IBES estimates

INRm	FY09e	FY10e	FY11e
Sales			
HSBC	227,870	271,850	323,296
Mean	227,131	278,575	333,982
High	247,310	310,679	373,107
Low	150,859	178,074	290,386
Variance	0%	-2%	-3%
EBITDA			
HSBC	92,138	100,831	114,313
Mean	93,267	111,766	131,354
High	100,722	128,831	149,675
Low	87,750	100,638	114,313
Variance	-1%	-10%	-13%
Net Income			
HSBC	55,895	44,951	42,978
Mean	57,810	48,511	52,924
High	64,510	61,575	65,644
Low	50,341	31,449	41,236
Variance	-3%	-7%	-19%

Source: IBES, HSBC estimates

Relative Performance – RCOM, Bharti and Idea



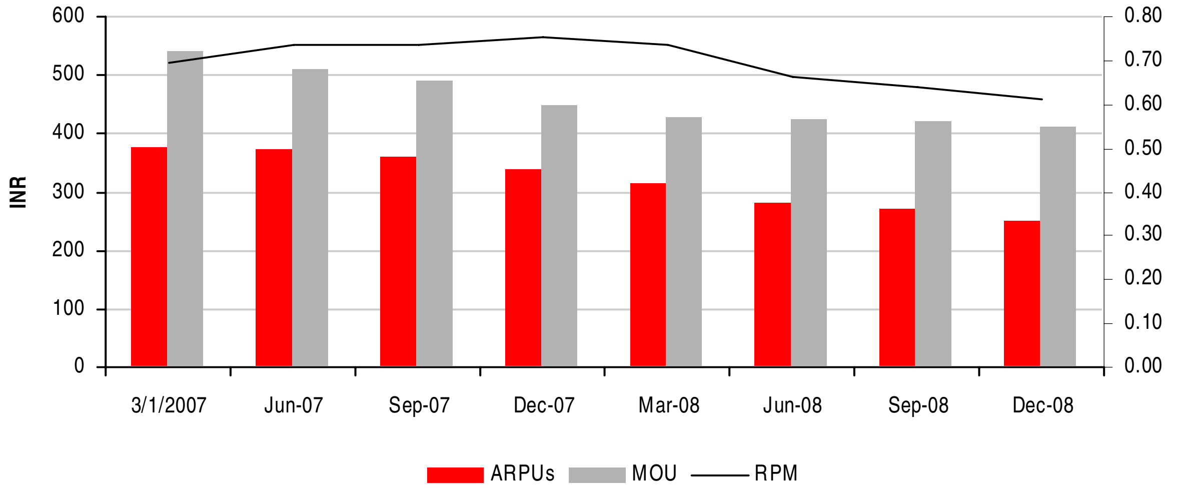
Source: HSBC

Valuations

Company	Ticker	CMP (INR)	Rating	TP (INR)	PE (x) FY09e	PE (x) FY10e	EV/EBITDA FY09e	EV/EBITDA FY10e	EV/Sub USD	Net debt/EBITDA FY09e	Net debt/EBITDA FY10e
Bharti	BHARTI.IN	604	OW(V)	786	13.7	12.3	7.9	6.7	216	0.53	-0.02
RCOM	RCOM.IN	138	N(V)	180	5.1	6.3	5.8	5.8	136	4.04	4.19
Idea Cellular	IDEA .IN	46	N(V)	48	17.6	14.5	6.5	6.3	96	1.20	2.32
Tata Teleservcies	TTLS IN	23	UW(V)	12	-23.2	-12.8	12.9	12.8	37	-8.18	-5.18

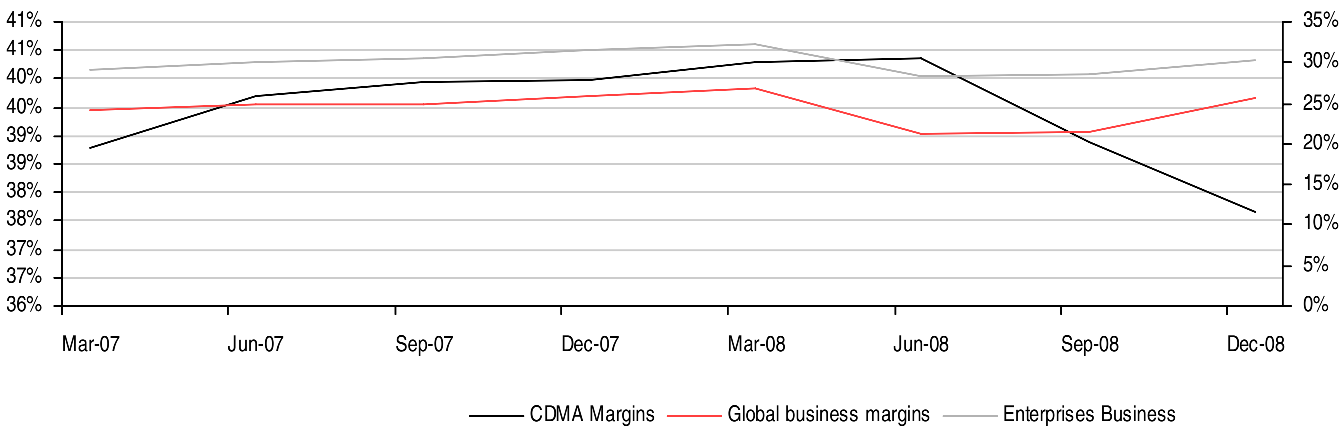
Source: HSBC estimates

Behaviour of CDMA ARPU, MOU and RPM over eight quarters



Source: HSBC

RCOM margins



Source: Company data

HSBC

The bull and bear case

- Investment in networks and competitive intensity are key criteria behind our bull and bear case
- We highlight that longer-term structural rating factors are related to improvement in network coverage
- Our analysis suggests a PE-based bull case range of INR223-261 and bear case range of INR101-123

Bull and bear case: The rationale

Over the last three months, RCOM has continuously underperformed and is down 74% in the last 12 months.

While factors such as likelihood of obtaining additional GSM spectrum, possibility of a stake sale in the tower business and progress on MNP are upside catalysts, factors such as execution risks with GSM, declining revenue market share and funding constraints continue to have a negative bearing on the share price movement. The sharp decline over the past three months (and the secular decline over the past 12 months) and upside catalysts prompt us to delve deeper and highlight a bull and bear case for the stock.

Our estimate of a 22% decline in FY10 earnings and the 74% decline in share price over the last 12 months suggest that RCOM has suffered a structural derating and we see no quick and easy catalyst to get the GSM business to scale and profitability, suggesting that the likelihood of a bull case is remote. We highlight that we are not layering explicit probabilities for the bull and bear case.

Base, bull and bear cases

Items	Base Case	Bear Case		Bull Case	
		Lower Range	Upper Range	Lower Range	Upper Range
CDMA EBITDA Margin	34%	28%	31%	35%	38%
GSM EBITDA Margin	18%	12%	14%	20%	25%
Mobile Business EBITDA Margin	31%	25%	28%	33%	36%
Global Business EBITDA Margin	25%	20%	22%	26%	28%
Consolidated EBITDA Margin	37%	31%	34%	38%	41%
EBITDA (INR m)	100,831	84,546	910,971	103,922	112,350
EPS (INR)	21.9	14.1	17.2	23.4	27.4
Discount to sensex	30%	40%	40%	20%	20%
Implied P/E	8.3	7.1	7.1	9.5	9.5
Implied Fair Value	182	101	123	223	261
Variation from base case	0%	-36%	-21%	7%	25%

Source: HSBC estimates

Sensitivity of change in CDMA and GSM margins on EPS

GSM Margins		CDMA Margins 29% -5%	30% -4%	31% -3%	34% Base Case	37% 3%	38% 4%	39% 5%
13%	-5%	16.86	17.71	18.55	21.09	23.62	24.46	25.31
14%	-4%	17.03	17.87	18.72	21.25	23.78	24.63	25.47
15%	-3%	17.19	18.03	18.88	21.41	23.95	24.79	25.64
18%	Base Case	17.68	18.53	19.37	**21.90**	24.44	25.28	26.13
21%	3%	18.17	19.02	19.86	22.39	24.93	25.77	26.62
24%	4%	18.66	19.51	20.35	22.89	25.42	26.26	27.11
25%	5%	18.83	19.67	20.51	23.05	25.58	26.43	27.27

Source: HSBC estimates

Bear case

What can drive mobile margins lower than our estimates?

Our base case for RCOM factors in a sceptical view of the GSM business, with the key reason being underinvestment in the network and therefore coverage gaps. With operations in 1800MHz we believe RCOM will find it difficult to move to profitable plans and target high ARPU subscribers until these coverage gaps are plugged.

The worst case scenario would arise primarily from a deepening of funding constraints and lower visibility on RCOM's ability to migrate to profitable plans in the medium term. We suggest a scenario where RCOM ends FY10 with less than c60,000 towers as a bear case. In such a scenario RCOM's wireless operating margins would deteriorate further. While RCOM may benefit from additional spectrum on the back of its entry level plans, incremental spectrum will not allow for any significant reduction in towers required for coverage.

Another point we assume for a bear case is increasing intensity of *competitive* and pricing pressures.

For the purpose of our bear case scenario, we are building in GSM EBITDA margins of 12-14% (base case 18%) and CDMA margins of 28-31% (base case 34%). This would result in consolidated mobile EBITDA margins varying between 25% and 28% (base case 31%).

Furthermore, we assume that global business margins range between 20% and 22% in the bear case (base case 25%). This would result in consolidated EBITDA margins of 31-34% (base case 37%). EPS at the lower end of the range would be INR14.1 (36% below our base case) and at the upper end of the range EPS would be INR17.2 (21% below our base case).

What if RCOM followed AS-11?

Rapid rupee depreciation has lead companies with external commercial borrowings and foreign currency convertible bonds (FCCB) to incur translation losses. This, coupled with falling share prices, means that the FCCBs could not get converted either.

RCOM has funded its expansion programs primarily through long-term borrowing in FCCBs. From FY09, RCOM switched from following accounting standard AS-11 to booking losses on forex fluctuations to the balance sheet and complying with Schedule VI of the Companies Act, 1956. However companies across the sector do not follow a consistent policy (e.g., Bharti follows US GAAP and accounts for forex losses/gains in the income statement).

It is worth highlighting that for companies adhering to AS-11, the translation gains/losses go through the income statement, while the Companies Act, 1956 allows the losses to be adjusted to the carrying cost of fixed assets.

Sensitivity of change in depreciation rate on EPS

Change in depreciation rate	FY10e Rate	FY10e EPS	FY11e Rate	FY11e EPS
Base Case	7.9%	21.9	8.2%	20.9
0.5%	8.4%	20.2	8.7%	19.0
1.0%	8.9%	18.4	9.2%	17.1
1.5%	9.4%	16.7	9.7%	15.2
2.0%	9.9%	15.0	10.2%	13.2

Source: HSBC estimates

If RCOM followed AS-11, net profit after tax for the first nine months of FY09e would have been lower by INR12.1bn for realised currency exchange loss and INR23.5bn for unrealised currency exchange loss. If we were to add and adjust net income for both the realised and unrealised foreign exchange losses, then net income would have declined 80% to INR8.8bn.

These forex losses do not include the INR11.4bn impact of FCCBs (considered a notional loss by the company). If we were to adjust these as well, RCOM would post a net loss of INR2.6bn.

While we are not suggesting that RCOM switch to AS-11 in FY09, the muted earnings after adjustments imply that RCOM warrants a lower multiple, particularly when its peers are not aggressive with their accounting policy.

Special audit

News reports (*Economic Times*) suggest that the DoT has appointed a Jaipur based accounting firm to conduct a special audit of the accounts and report findings in three months. As per media reports, the DoT has established a six member committee to frame the terms and references for the special audit. The audit would primarily look into differential reporting of revenues to shareholders and the TRAI (revenue reported to TRAI for the purpose of spectrum and license fee charges).

As per our analysis there is a significant gap between gross revenues reported by RCOM to the TRAI and shareholders (c26% lower revenue reported to TRAI in September 2008). The company suggests that this difference is due to data cards and revenues from Reliance Web World (R-World). RCOM also suggests that such revenues are from the Internet service provider (ISP) license, which does not attract any licence and spectrum fee (only ISP operators pay a VOIP attract license fee). As a result, the licence fee has largely remained unchanged for the past few quarters.

Valuation range

We build in a higher discount for our bear case given that RCOM does not follow AS-11 and is subject to the special audit.

We apply a higher 40% discount to the Sensex for our bear case; applying it to our lower and upper EPS range of INR14.1 and INR17.2, we arrive at a bear case range of INR101-123, respectively.

RCOM - Accounting issues – Difference in revenue reported to TRAI and shareholders

INR m	Dec-06	Mar-07	Jun-07	Sep-07	Dec-07	Mar-08	Jun-08	Sep-08
Gross revenues reported to TRAI	26,356	28,261	31,382	29,063	32,883	33,146	31,608	34,182
Reported to shareholders	27,520	29,692	33,730	37,230	39,567	41,608	41,187	43,356
Diff in rev reported to TRAI		5.1%	7.5%	28.1%	20.3%	25.5%	30.3%	26.8%
Net revenues reported to TRAI	20,174	19,322	21,972	19,880	22,927	22,864	22,112	20,447
Reported to shareholders	19,308	20,673	24,244	27,722	28,892	31,757	31,280	33,626
Diff in rev reported to TRAI		7.0%	10.3%	39.4%	26.0%	38.9%	41.5%	64.5%

Source: Company data, HSBC

Bull case

Discussion of the bull case requires us to take a step back and look at the period when RCOM commanded a premium to the Sensex. We believe the premium was awarded to its strategy to unlock value in tower and fibre assets and fund GSM capex.

We believe the bull case is driven by easing of funding constraints, which would allow RCOM to increasing investments in networks. We note that improvement in network coverage would lead to improvement in revenue realisation from the mobile business. We highlight longer-term structural rerating factors such as ability to penetrate rural India, benefits from MNP, ability to close the revenue market share gap with Bharti and improvement in realisation rates as underpinning RCOM's ability to improve network coverage.

If we relate a bull case scenario to specific data points, we would suggest a scenario whereby RCOM is able to deploy c80,000 GSM towers by end FY10e or even earlier.

For the purpose of our bull case we also assume easing of competitive intensity and lower termination charges.

Easing of funding constraints

Easing of funding constraints could come from a stake sale in the tower business in the near to medium term.

While unlocking the tower business would be positive for funding, we highlight that visibility of the tower business will gather momentum only when RCOM is able to tap external tenants with viable business models. Therefore, we do not expect a significant run-up in the stock on the back of a stake sale in the tower business, until it is supported by external tenants.

Bull case assumptions

For the purpose of our bull case scenario, we assume GSM EBITDA margins in the range of 20-25% (base case 18%) and CDMA margins in the range of 35-38% (base case 34%). This leads to consolidated mobile EBITDA margins of 33-36% (base case 31%).

Furthermore, we assume that global business margins range between 26% and 28% (base case 25%). Consolidated EBITDA margins would vary in the range of 38-41% (base case 37%). EPS would be INR23.4 (7% above our base case) at the lower end of the range while EPS would be INR27.4 (25% above our base case) at the upper end of the range.

Valuation range

In our view, catalysts such as ability to unlock value and better visibility about improvements in network coverage will lead to re-rating of investor sentiment; as such the stock would command a lower discount to our Sensex target multiple of 20% (base case discount is 30%).

Applying this PE to our lower and upper EPS range of INR23.4 and INR27.4, we arrive at a bull case range of INR223-261, respectively.

RCOM vs. Bharti

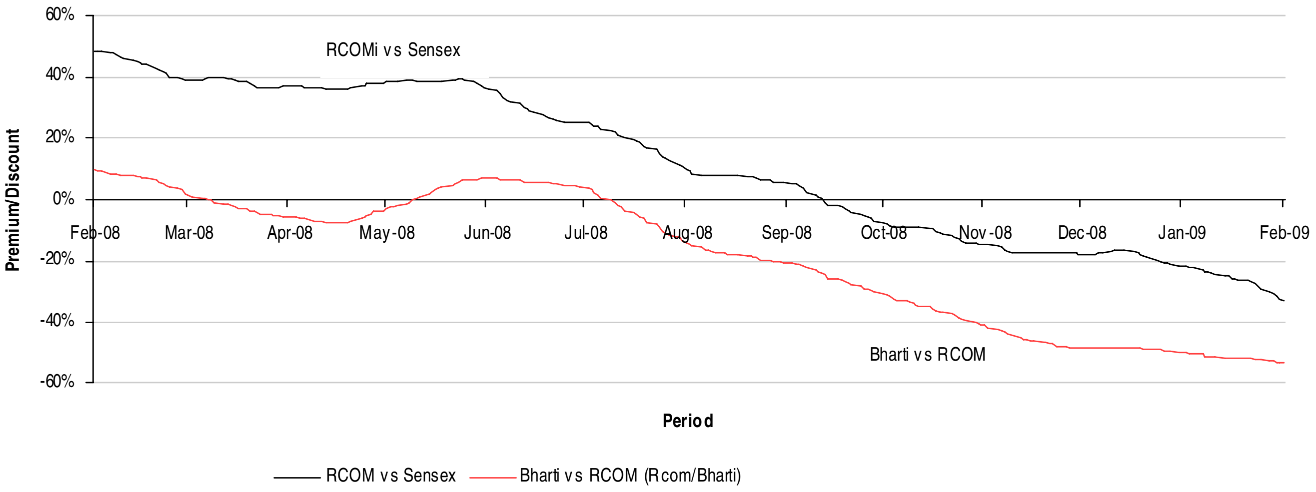
A frequently asked question is what discount RCOM should trade at versus Bharti. Our analysis suggests the discount has increased from 3% to 63% over the past 12 months. Similarly the discount vis-à-vis the Sensex has increased from -22% to 49% over the past 12 months.

Factors such as accounting issues, investor concerns about the results of the special audit, differential treatment of forex losses, RCOM's stretched balance sheet and Bharti's consistent gain of revenue market share have resulted in a widening of the discount.

We reiterate that on the back of rising competitive intensity, subscriber-based metrics will lose relevance and hence investors are better to focus on revenue and EBITDA market share.

We believe the discount could narrow and move in favour of RCOM if investors become more positive on the longer-term structural aspects, which will be driven by easing of funding constraints and clarity about the CDMA strategy. We believe the issue of running dual networks will become a concern in the near to medium term, and a clear policy on this front would be helpful.

Premium/discount of RCOM versus Sensex & Bharti



Source: HSBC

Concerns about leveraging

- Rising competitive intensity favours players with strong balance sheets
- With 4x FY10e Net debt/EBITDA, RCOM is among the most leveraged companies in the telecom space
- Outstanding FCCBs of USD1.5bn payable in March 2011 (USD0.5bn) and February 2012 (USD1bn)

Net debt/EBITDA for telecoms

Different accounting policies pursued by companies across the sector prevent us from focussing on debt/equity and interest coverage ratios; hence, we advise investors to place more stress on Net debt/EBITDA numbers.

Reference can be made to the different policies followed by Bharti and RCOM in accounting for forex losses: Bharti follows US GAAP and accounts for forex losses/gains in the income statement; RCOM pursues a relatively aggressive accounting policy. RCOM capitalises the short-term fluctuations in forex related to liabilities and borrowings which have been used for the purpose of financing the acquisition of fixed assets (note RCOM has funded its capex plans largely with FCCBs), but books gains/losses on corresponding hedges in the income statement.

The fact that telecoms is capital intensive business highlights that players with stretched balance sheets tend to lose in the longer term. With its foray in GSM and frequency allocations in 1800MHz, funding requirements for RCOM are likely to remain at the higher end, assuming it moves toward ramping up rural coverage.

Admittedly FY10e capex may reflect a period of peak funding; we are of the view that RCOM would need c70,000- 75,000 base stations in an attempt to match the coverage of large incumbents. If RCOM were to end the year with c48,000 towers it would require investments in another c25,000 towers over the next 12 months, suggesting that FY10e capex guidance may have to be revised higher if RCOM plans to invest more in the mobile business.

Funding options

In our view, RCOM's ability to tap capital markets to raise funds looks limited due to poor sentiment and weak global cues. With FIIs continuing to sell down and overall funding via IPOs declining to negligible levels, equity financing as an attractive financing option looks limited.

Another option could be pledging of shares, however the fact that RCOM has already pledged a fair portion, suggests that further pledging is unlikely.

Other options for RCOM include:

- Stake sale in the tower business (already reported in the media that RCOM is considering 5-10% stake sale in the tower arm)
- Stake sale in the fibre business
- Equity dilution in the parent company by introducing a strategic partner (reported in the media)
- Incremental borrowing
- Restructuring options

We highlight that current liabilities have nearly doubled since the quarter ended June 2007 and this has a positive bearing with the build up of capital work in progress (GSM project). As such we have assumed the incremental current liability as part of the adjusted gross debt numbers. The incremental current liability being considered represents c50% of the present current liability.

Incremental borrowing and how net debt/EBITDA looks

In a recent development, credit rating agency ICRA has assigned an LAAA rating to RCOM's INR30bn non-convertible debenture programme and INR100bn proposed long-term fund based facilities. Adding the two we arrive at INR130bn, and highlight this is an attempt to arrange funds to meet the capex guidance of INR150bn for FY10e.

If RCOM were to meet our base case ARPU assumptions (GSM INR151 and CDMA INR245), we estimate cash flow from operations of USD1.8bn for FY10, also assuming that competition does not intensify and RCOM moves to profitable plans it would only draw to the extent of USD1.3bn (INR65bn). Moreover, incremental cash inflow from a stake sale in the tower business could significantly ease funding constraints. Our analysis suggests that if tower unlocking raises cUSD1bn, adjusted net debt/EBITDA would improve to 3.7x (base case adjusted net debt/EBITDA at 4.19x) in FY10e.

We highlight that incremental funding via debt would limit RCOM's ability to assume additional debt, and this could be negative as we expect 3G auctions over the next 12 months.

Pledged shares

	% of shares pledged (total shares)	Promoter holding	% of promoter holding pledged	Mcap (USD m)	Value of pledged shares (USD m)
RCOM	13%	66%	20%	5401	713
TCOM	11%	76%	14%	223	234

Source: HSBC

Details of FCCBs

Issued currency	Maturity	Conversion price (INR)	Redemption premium	Effective conversion price (INR)
USD500m	11-May	480.6	125.8	605
USD 1bn	12-Feb	661.2	127.6	844

Source: HSBC

Net debt/EBITDA

Items	FY09e	FY10e	FY11e
Net Debt w/o adj (INR m)	253,094	304,819	277,184
CL adjustment (INR m)	118,786	117,312	153,248
Net Debt (INR m)	**371,880**	**422,131**	**430,432**
EBITDA (INR m)	92,138	100,831	114,313
Net debt/EBITDA w/o adj.	2.75x	3.02x	2.42x
Net debt/EBITDA	4.04	4.19	3.77

Source: HSBC estimates

RCOM - PE band one-year forward

Source: HSBC

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Rating definitions for long-term investment opportunities

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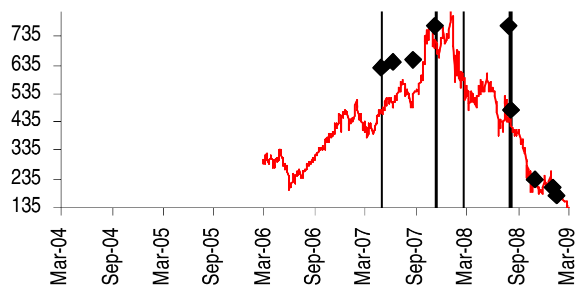
Underweight (Sell)	23%	(25% of these provided with Investment Banking Services)

Share price and rating changes for long-term investment opportunities

Reliance Communication (RLCM.NS) Share Price performance INR Vs HSBC rating history



Source: HSBC

Recommendation & price target history

From	To	Date
N/A	Overweight (V)	03 May 2007
Overweight (V)	Neutral	15 November 2007
Neutral	Restricted	22 February 2008
Restricted	Neutral	04 August 2008
Neutral	Neutral (V)	15 August 2008
Target Price	**Value**	**Date**
Price 1	624.00	03 May 2007
Price 2	644.00	12 June 2007
Price 3	651.00	23 August 2007
Price 4	775.00	15 November 2007
Price 5	Restricted	22 February 2008
Price 6	775.00	04 August 2008
Price 7	475.00	15 August 2008
Price 8	235.00	05 November 2008
Price 9	202.00	13 January 2009
Price 10	180.00	27 January 2009

Source: HSBC

HSBC & Analyst disclosures

Disclosure checklist

Company	Ticker	Recent price	Price Date	Disclosure
RELIANCE COMMUNICATION	RLCM.NS	137.90	06-Mar-2009	1, 2, 5

Source: HSBC

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