

Telecoms, Media & Technology
Diversified Telecoms
Equity – India

Neutral

Target price (INR)	152
Share price (INR)	135
Potential return (%)	12

Performance	1M	3M	12M
Absolute (%)	7.3	-25.1	-25.2
Relative ^A (%)	8.9	-21.1	-31.8

Index ^A	BOMBAY SE IDX
RIC	RLCM.NS
Bloomberg	RCOM IN

Market cap (USDm)	6,147
Market cap (INRm)	279,160
Enterprise value (INRm)	520509
Free float (%)	35

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

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Rajiv Sharma*

Analyst
HSBC Securities and Capital Markets
(India) Private Limited
+9122 2268 1239
rajivsharma@hsbc.co.in

Harbhajan Singh*

Associate
Bangalore

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Reliance Communications

Upgrade to Neutral on valuation

- ▶ **See limited impact on operations from the CAG report-related actions, but expect sentiment to weigh on the stock**
- ▶ **Break-up value of assets to provide downside support**
- ▶ **Upgrade to N from UW (removing V flag); cut target price to INR152 from INR170**

The stock has declined 7% y-t-d (-22% in last two months) and now trades at a 12-month forward PE of 13x. We believe the sell-off is due to: a) overall market weakness, and b) concerns related to the Comptroller and Auditor General of India (CAG) report that alleges that the Department of Telecommunications (DoT) gave undue benefit to RCOM while issuing the dual technology license, and violation of the cross-holding norms by RCOM. The company has denied these allegations. Although we see minimal impact on operations from any finding of the CAG report, the related overhang is likely to continue to weigh on the stock for the next few quarters. Separately, we believe visibility on strategic initiatives (26% stake sale and tower monetisation) has diminished, given market conditions. Consequently, we are lowering our target PE multiple from 15x to 13x and cut our target price to INR152. However, given the sell-off, we raise our rating to Neutral.

Expect the stock to be range bound. We believe the value of RCOM's assets is likely to provide downside support at the current level, which we estimate at INR130. That said, we also see limited upside, given balance sheet concerns.

How have we computed NAV? We derive NAV using separate values for the GSM, CDMA, 3G business and tower/fibre assets held by the company. We value all businesses based on the potential value of the spectrum and we have used a discount to the 3G spectrum to arrive at the fair values. Our base-case NAV implies an EV/subscriber of USD125 for the GSM business (about 35% discount to Bharti's wireless business) and USD102 for the CDMA business.

Key positives are a) MNP and benefits from churning high-end subscribers – we see limited upside given RCOM's underinvested GSM network, and b) improved tower tenancy due to BWA launches. **Key negatives** are a) a PE de-rating on account of potential fines on the back of any CAG report findings, and b) loss of CDMA subs post MNP introduction.

We upgrade RCOM to Neutral from UW(V), but cut the target price to INR152 as we lower our target PE multiple to 13x (15x). The key upside risk is RCOM's ability to sell a 26% stake and monetise the tower assets. Further acceptance of the TRAI recommendation in the current format would also be positive for the stock. The key downside risks are lower-than-estimated ARPU and slower-than-estimated ramp-up in data.

Financials & valuation

Financial statements

Year to	03/2010a	03/2011e	03/2012e	03/2013e
Profit & loss summary (INRm)				
Revenue	222,504	216,103	250,023	284,943
EBITDA	78,870	70,529	80,665	94,388
Depreciation & amortisation	-37,466	-40,129	-45,135	-50,066
Operating profit/EBIT	41,404	30,400	35,531	44,322
Net interest	11,863	-12,272	-10,983	-11,262
PBT	52,891	18,128	24,548	33,060
HSBC PBT	53,267	18,128	24,548	33,060
Taxation	-4,454	-858	-4,173	-6,447
Net profit	47,041	15,583	18,672	24,893
HSBC net profit	47,344	15,583	18,672	24,893

Cash flow summary (INRm)

Cash flow from operations	53,494	89,338	95,984	109,924
Capex	-41,587	-115,142	-40,593	-45,466
Cash flow from investment	-41,445	-114,560	-40,593	-45,466
Dividends	0	0	0	0
Change in net debt	-83,105	42,462	-44,528	-51,041
FCF equity	62,127	-40,969	40,235	46,749

Balance sheet summary (INRm)

Intangible fixed assets	52,215	118,333	118,333	118,333
Tangible fixed assets	663,180	662,745	653,912	645,019
Current assets	164,152	165,286	168,667	172,074
Cash & others	48,585	48,000	48,000	48,000
Total assets	880,746	947,594	942,141	936,655
Operating liabilities	198,855	208,918	227,618	246,561
Gross debt	247,473	289,350	244,822	193,781
Net debt	198,888	241,350	196,822	145,781
Shareholders funds	387,825	401,342	420,014	444,908
Invested capital	632,107	689,446	665,294	640,866

Ratio, growth and per share analysis

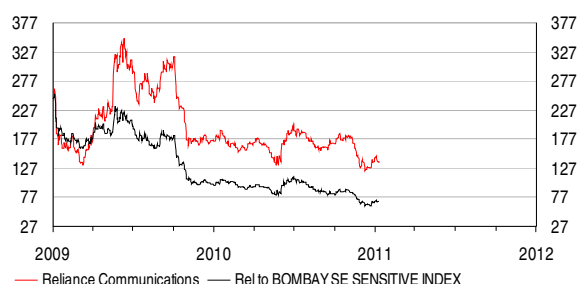
Year to	03/2010a	03/2011e	03/2012e	03/2013e
Y-o-y % change				
Revenue	-3.0	-2.9	15.7	14.0
EBITDA	-15.1	-10.6	14.4	17.0
Operating profit	-22.7	-26.6	16.9	24.7
PBT	-13.8	-65.7	35.4	34.7
HSBC EPS	-20.0	-67.3	19.8	33.3
Ratios (%)				
Revenue/IC (x)	0.3	0.3	0.4	0.4
ROIC	5.5	4.4	4.4	5.5
ROE	11.7	3.9	4.5	5.8
ROA	3.9	3.2	3.1	3.8
EBITDA margin	35.4	32.6	32.3	33.1
Operating profit margin	18.6	14.1	14.2	15.6
EBITDA/net interest (x)		5.7	7.3	8.4
Net debt/equity	50.3	58.9	45.7	31.9
Net debt/EBITDA (x)	2.5	3.4	2.4	1.5
CF from operations/net debt	26.9	37.0	48.8	75.4
Per share data (INR)				
EPS reported (fully diluted)	22.92	7.55	9.05	12.06
HSBC EPS (fully diluted)	23.07	7.55	9.05	12.06
DPS	0.00	0.00	0.00	0.00
Book value	188.98	194.45	203.50	215.56

Valuation data

Year to	03/2010a	03/2011e	03/2012e	03/2013e
EV/sales	2.1	2.4	1.9	1.5
EV/EBITDA	6.1	7.4	5.9	4.5
EV/IC	0.8	0.8	0.7	0.7
PE*	5.9	17.9	15.0	11.2
P/Book value	0.7	0.7	0.7	0.6
FCF yield (%)	22.3	-14.7	14.4	16.7
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 10 Jan 2011

Analysis and computations

Figure 1: RCOM alternative asset valuation

Particulars	Bear case	Bull case
Figs in USDm unless stated		
2G Spectrum	1,834	2,040
3G Spectrum	1,240	2,099
CDMA	1,834	1,793
Towers	5,556	7,000
Optic Fibre	2,000	2,000
EV	12,465	14,931
Net debt	6,487	6,487
Equity value	5,978	8,445
Value per share (INR)	130	184

Source: HSBC estimates

We value RCOM based on its spectrum bank and other assets, such as towers and optic fibre network, as in our view these provide downward support for the stock.

Bear case: We value RCOM's GSM and CDMA spectrum at 5x the license fee paid to acquire these licenses from the government. We value its towers at an EV/tower of USD5m and not EV/tenant (as the external tenancy on its towers is very low), as implied by recent tower transactions. We value its 3G spectrum at 65% of the price paid for the auction and, as such, view it to be value destructive. We value its fibre business at USD2bn. This implies a value per share of INR130.

Bull case: We value RCOM's GSM business at 60% of the 3G prices on the premise that the company will shift its high-end subs to 3G, which will allow it to better utilise its 2G spectrum. We value its CDMA spectrum at 50% of the 3G prices and view it as complementing its 3G data card business. We value its tower assets at an EV/tower of USD6.3m, as implied by the deal with GTL Infra. We project the 3G capex to yield a return of 10% of the price paid for the auction and, as such, view it to be value accretive. We value its fibre business at USD2bn. This implies a value per share of INR184.

Catalysts

Mobile number portability

While mobile number portability (MNP) gives RCOM an opportunity to grab high-end subscribers from its competitors, its poor coverage in 2G remains a concern. Nevertheless, MNP also exposes it to the risk of losing CDMA subscribers, who so far had limited options. Although shifting to GSM will require subscribers to invest in 2G handsets, for some this may coincide with the handset replacement cycle.

We believe CDMA subscribers did not change operators for two reasons: 1) to retain their numbers; and 2) not to waste their investment in the CDMA handset. We note on average, a handset has a useful life of up to three years. Post MNP, subscribers who are at the end of their handset life will likely start shifting to GSM, as they no longer have to be locked to an operator. Also, they can change the operator without changing the number. Given this possibility, we do not see clear positives for RCOM from MNP introduction.

3G and data business

RCOM currently offers data cards on its CDMA network and is expanding the coverage of its EVDO cards to 150 towns. The company has won 3G spectrum in 13 circles, including all of its eight 900 MHz band markets. It was the second private operator to launch 3G services in India, in December 2010. While it is suitably positioned to benefit in the data card segment, we believe its ability to benefit from wireless broadband is limited, given the lack of high-end subscribers. RCOM's current GSM coverage is insufficient and it needs to invest more in tower infrastructure to meaningfully attract high-end subscribers. We estimate RCOM's 3G adoption rate at 11% by FY15, and expect the company to be focussed more on the devices and data card market.

Valuation and rating

We value RCOM using a 12-month target price based on a blended approach of PE and DCF (equal weight). For our DCF valuation, we assume a cost of equity of 13% (HSBC's Strategy Team has computed a baseline cost of equity of 11% for India, and we assume a rate 200bp above that to factor in competitive intensity, accounting issues and risks associated with a stretched balance sheet), cost of debt of 10.5%, WACC of 13% and a terminal growth rate of 3.5%. This produces a fair value of INR186 per share.

For the PE valuation, we have lowered our target multiple to 13x from 15x. Our earlier target multiple of 15x factored in the potential benefits from RCOM's plans to monetise the tower assets and to introduce a strategic investor by selling a 26% stake. As we do not see any visibility on this in the near future, we lower our target multiple to 13x, which at FY12e EPS implies a value of INR110 per share. Blending both approaches, we arrive at a fair value of INR152 per share for the core business.

Under our research model, for stocks without a volatility indicator, the Neutral band is 5 percentage points above and below our hurdle rate for Indian stocks of 11%, or 6-16% around the current share price. Our INR152 target price represents a potential return of 12%, which implies a Neutral rating for the stock; hence, we upgrade RCOM to Neutral from UW(V).

Figure 2: RCOM target price computation

Particulars	Remarks	Value (INR)
DCF	WACC of 13% (cost of equity 13%, cost of debt 10.5%) terminal growth rate 3.5%	186
PE	13x FY12e PE	118
Target price	Assigning 50% weightage to each	152

Source: HSBC estimates

Figure 3: RCOM: HSBC vs. consensus (INRm unless stated otherwise)

	FY11e	FY12e	FY13e
Sales			
HSBC	216,103	250,023	284,943
Consensus	225,479	254,846	290,678
Variance	-4%	-2%	-2%
EBITDA			
HSBC	70,529	80,665	94,388
Consensus	72,447	84,293	98,305
Variance	-3%	-4%	-4%
Net Income			
HSBC	15,583	18,672	24,893
Consensus	20,057	24,451	32,722
Variance	-22%	-24%	-24%
EPS (INR)			
HSBC	7.6	9.0	12.1
Consensus	9.5	11.6	15.4
Variance	-21%	-22%	-22%

Source: HSBC estimates, Datastream

Figure 4: RCOM 3Q FY11 estimates (INRm unless stated otherwise)

	HSBC Estimates	2QFY11	3QFY10	QoQ	YoY	Consensus	Variance
Overall Business							
Revenue	53,708	51,183	53,098	4.9%	1.1%	54,651	-2%
EBITDA	17,021	16,595	18,126	2.6%	-6.1%	17,404	-2%
EBITDA Margin (%)	31.7%	32.4%	34.1%	-0.7%	-2.4%	31.8%	0%
Net Profit	2,623	4,459	11,077	-41.2%	-76.3%	3,779	-31%
EPS (INR)	1.3	2.2	5.4	-41.2%	-76.3%	1.8	-31%

Source: HSBC estimates

Figure 5: RCOM operating parameters estimates for 3QFY11 estimates

	HSBC estimates	2QFY11	3QFY10	QoQ	YoY
ARPU (INR)	120	122	149	-2.0%	-19.7%
MoU (minutes)	280	276	330	1.5%	-15.2%
Mobile revenues (INRm)	43,574	41,613	40,225	4.7%	8.3%
EBITDA (INRm)	12,419	12,101	12,545	2.6%	-1.0%
EBITDA Margin	28.5%	29.1%	31.2%	-0.6%	-2.7%

Source: HSBC estimates

Disclosure appendix

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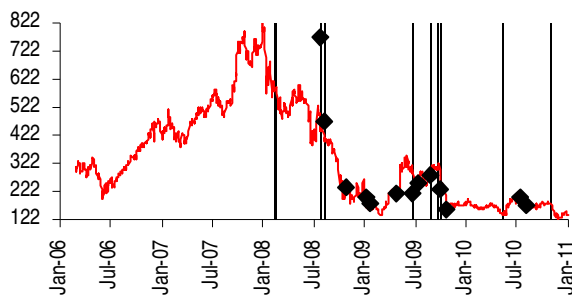
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Neutral (Hold)	38%	(19% of these provided with Investment Banking Services)
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Share price and rating changes for long-term investment opportunities

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



Source: HSBC

Recommendation & price target history

From	To	Date
Neutral	Restricted	22 February 2008
Restricted	Neutral	04 August 2008
Neutral	Neutral (V)	15 August 2008
Neutral (V)	Underweight (V)	29 June 2009
Underweight (V)	Neutral (V)	01 September 2009
Neutral (V)	Restricted	25 September 2009
Restricted	Underweight (V)	07 October 2009
Underweight (V)	Neutral (V)	20 May 2010
Neutral (V)	Underweight (V)	08 November 2010
Target Price	Value	Date
Price 1	Restricted	22 February 2008
Price 2	775.00	04 August 2008
Price 3	475.00	15 August 2008
Price 4	235.00	05 November 2008
Price 5	202.00	13 January 2009
Price 6	180.00	27 January 2009
Price 7	218.00	05 May 2009
Price 8	214.00	29 June 2009
Price 9	250.00	23 July 2009
Price 10	280.00	01 September 2009
Price 11	Restricted	25 September 2009
Price 12	227.00	07 October 2009
Price 13	158.00	02 November 2009
Price 14	197.00	21 July 2010
Price 15	170.00	13 August 2010

Source: HSBC

HSBC & Analyst disclosures

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Company	Ticker	Recent price	Price Date	Disclosure
RELIANCE COMMUNICATIONS	RLCM.NS	135.25	11-Jan-2011	2, 5, 7

Source: HSBC

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Issuer of report

HSBC Securities and Capital Markets (India) Private Limited

Registered Office

52/60 Mahatma Gandhi Road
Fort, Mumbai 400 001, India

Telephone: +91 22 2267 4921

Fax: +91 22 2263 1983

Website: www.research.hsbc.com

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