Q3FY11 Result Update

February 21, 2011

RCOM recently declared its Q3FY11 results. It reported consolidated net revenues of Rs.4,824.6 cr down by 5.9% Y-o-Y and down by 3% Q-o-Q on account of poor performance from all business segments. EBIDTA for the quarter fell by 14.4% Y-o-Y and by 2.3% Q-o-Q to Rs.1,528.9 cr. PAT margins contracted by 1160 bps Y-o-Y but improved by 100 bps Q-o-Q to 10%. Margins were lower on the back of cost over runs and lower revenues.

Quarterly Financials - Consolidated

Rs.Cr.

Particulars	Q3FY11	Q3FY10	% Chg	Q2FY11	% Chg	9MFY11	9MFY10	% Chg
Net Sales	4824.6	5129.0	-5.9%	4972.6	-3.0%	14812.1	15986.8	-7.3%
Other Operating Income	40.4	154.6	-73.9%	50.4	-19.8%	144.3	636.0	-77.3%
Total Operating Income	4865.0	5283.6	-7.9%	5023.0	-3.1%	14956.5	16622.8	-10.0%
Operating Expenses								
- Access Charges & License Fees	947.0	833.7	13.6%	960.5	-1.4%	2878.7	2386.7	20.6%
- Network Operations	1249.3	1670.8	-25.2%	1381.3	-9.6%	3938.5	4648.3	-15.3%
- Personnel Exp	355.8	367.7	-3.2%	359.6	-1.1%	1069.0	1160.5	-7.9%
- SG&A	784.0	625.0	25.4%	757.4	3.5%	2386.0	2677.1	-10.9%
Total Opex	3336.1	3497.2	-4.6%	3458.8	-3.5%	10272.2	10872.6	-5.5%
EBIDTA	**1528.9**	**1786.4**	-14.4%	**1564.2**	-2.3%	**4684.3**	**5750.2**	-18.5%
EBIDTA Margins %	*31.7%*	*34.8%*		*31.5%*		*31.6%*	*36.0%*	
Other Income	139.1	26.2	431.0%	95.3	46.0%	275.1	534.7	-48.5%
Interest	129.6	-407.6	-131.8%	279.7	-53.7%	849.0	-372.9	-327.7%
Depreciation	1033.8	833.1	24.1%	955.3	8.2%	2953.8	2661.9	11.0%
Amortisation of compensation under ESOP	0.0	22.1	-	0.0	-	0.0	36.0	-
PBT	504.6	1365.0	-63.0%	424.5	18.9%	1156.6	3960.0	-70.8%
PBTM %	*10.5%*	*26.6%*		*8.5%*		*7.8%*	*24.8%*	
Tax	-21.4	200.3	-110.7%	-66.1	-67.6%	-159.4	253.1	-163.0%
Effective Tax Rate %	*-4.2%*	*14.7%*		*-15.6%*		*-13.8%*	*6.4%*	
Share of minority and associates	45.7	56.8	-19.6%	44.7	2.2%	139.0	222.0	-37.4%
PAT	**480.3**	**1108.0**	-56.7%	**445.9**	7.7%	**1177.0**	**3484.9**	-66.2%
PATM %	*10.0%*	*21.6%*		*9.0%*		*7.9%*	*21.8%*	
Equity	1032.0	1032.0	0.0%	1032.0	0.0%	1032.0	1032.0	0.0%
EPS	**2.3**	**5.4**	-56.7%	**2.2**	7.7%	**5.7**	**16.9**	-66.2%

(Source: Company Press Release)

Quarterly Financials – Segmental

Rs.Cr.

Segmental	Q3FY11	Q3FY10	% Chg	Q2FY11	% Chg	9MFY11	9MFY10	% Chg
Gross Revenues								
- Wireless	4064.4	4022.5	1.0%	4161.3	-2.3%	12378.5	12825.6	-3.5%
- Global	1923.3	1981.8	-3.0%	1839.1	4.6%	5576.2	6130.5	-9.0%
- Broadband	618.4	704.5	-12.2%	661.7	-6.5%	1956.4	2158.7	-9.4%
- Others	310.7	316.0	-1.7%	398.4	-22.0%	1043.9	895.1	16.6%
Eliminations	-1912.7	-1715.1	11.5%	-1942.2	-1.5%	-5723.3	-4852.4	17.9%
Total revenues	**5004.1**	**5309.7**	-5.8%	**5118.3**	-2.2%	**15231.6**	**17157.5**	-11.2%
EBIDTA								
- Wireless	1179.2	1254.5	-6.0%	1210.1	-2.6%	3588.2	4416.6	-18.8%
- Global	396.6	419.4	-5.4%	339.3	16.9%	1067.6	1393.6	-23.4%
- Broadband	226.7	275.5	-17.7%	248.1	-8.6%	722.5	894.8	-19.3%
- Others	-134.5	-125.5	7.2%	-134.3	0.1%	-403.8	-388.0	4.1%
Eliminations	0.0	-11.8	-100.0%	-3.7	-100.0%	-15.0	-32.6	-54.0%
EBIDTA	**1668.0**	**1812.1**	-8.0%	**1659.5**	0.5%	**4959.5**	**6284.4**	-21.1%
EBIDTA Margins %								
- Wireless	29.0%	31.2%		29.1%		29.0%	34.4%	
- Global	20.6%	21.2%		18.4%		19.1%	22.7%	
- Broadband	36.7%	39.1%		37.5%		36.9%	41.5%	

- Others	-43.3%	-39.7%		-33.7%		-38.7%	-43.3%	
Eliminations	0.0%	0.7%		0.2%		0.3%	0.7%	
EBIDTA Margins %	**33.3%**	**34.1%**		**32.4%**		**32.6%**	**36.6%**	

(Source: Company Press Release)

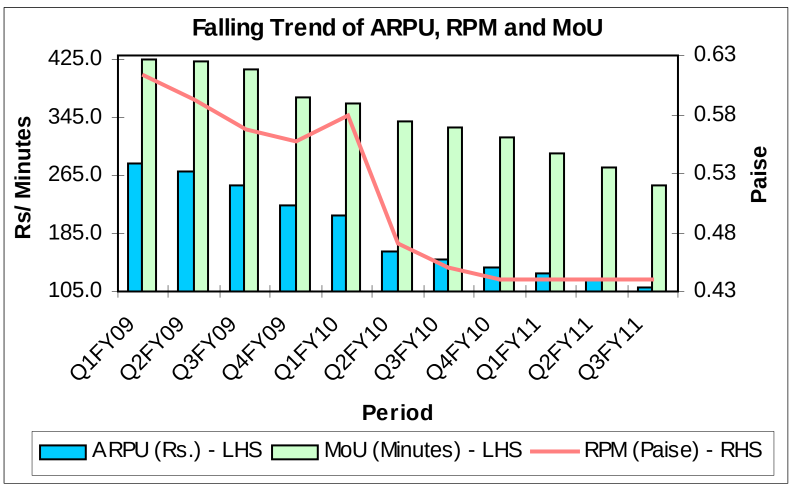
Some of the key highlights of the results are as follows:

- RCom reported a 5.5% y-o-y degrowth and 3.0% q-o-q degrowth in revenues to Rs.4,824.6 cr.

Poor wireless performance:

- Wireless revenues rose by only 1% y-o-y to Rs.4,064.4 cr only despite a 33.9% y-o-y growth in subscriber base. Even sequentially it saw a degrowth by 2.3%. RCom reported lowest ARPU ever of Rs.111 in Q3FY11. RPM remained stable q-o-q at 44 paise in Q3FY11. Wireless EBIDTA margin fell by 220 bps y-o-y to 29% (but was flat q-o-q) on account of sharp increase in marketing cost. RCom saw minute degrowth (compared to growth witnessed by Bharti & Idea (~4.5% and 10.2% q-o-q respectively)) of 3.3% q-o-q to 91.5bn. The management is on high focus to re-frame its wireless business and it is continuously reducing free minutes on the network from last quarter. It is betting high on the data usage with the higher spectrum availability post phase out of free minutes. The management has indicated stabilisation in MoU in next couple of quarters as the free minutes would be taken out from network.

- The management cited portfolio re-balancing wherein low margin PCO/wholesale business is undergoing a ramp down; CDMA spectrum would be used increasingly for high-speed internet services. This highlights the challenges facing RCom in reviving traffic growth without enjoying the flexibility to cut tariffs anymore.



(Source: Company Press Release)

On-going launch of 3G services:

- RCom has launched 3G services in 3 metro circles of Delhi, Mumbai and Kolkatta. It plans to launch in its remaining 10 circles by end of March 2011. It also plans to launch 3G services in the balance 9 circles in FY12 alongwith other like-minded, quality 3G licensees.

Other businesses results too were weak:

- The global business segment revenues degrew by 3% y-o-y but grew by 4.6% q-o-q to Rs.1,923.3 cr. ILD traffic grew sharply by 44.7% y-o-y and 8.8% q-o-q to 4.1 bn minutes while NLD traffic rose by 21.4% y-o-y and by 1.1% q-o-q to 16.6 bn minutes. However Revenue per minute fell by 22.6% y-o-y, but improved 2% q-o-q. RCom is witnessing stability in terms of both orders coming into the global business with Europe stabilizing a little bit and US also stable. PBIT margins in global business on a q-o-q basis improved by 220 bps to 20.6% in Q3FY11.

- Broadband segment revenues fell by 12.2% y-o-y and 6.5% q-o-q to Rs.618.4 cr with ARPL down by 16.1% y-o-y and 7.8% q-o-q to Rs.1,377. PBIT margins witnessed contraction of 80 bps q-o-q and 240 bps y-o-y to 36.7%.

- The global and enterprise business has been combined to make it look as a more attractive unit for investors. Q3FY11 witnessed the largest in-bound traffic for RCom.

Growing DTH business:

- RCom had 3.3 mn DTH subscribers in Q3FY11 up from 2.9 mn subscribers in Q2FY11 and a market share of 11%. Reliance Big TV is available at more than 100,000 outlets across 6,500 towns in the country. The retail and distribution reach, as well as other elements of infrastructure established for its wireless network, have been leveraged to expand its DTH presence. RCom plans to launch High Definition set top box soon.

Margins under pressure due to higher costs and lower revenues:

- Consolidated EBIDTA margins dipped by 310 bps y-o-y to 31.7% on the back of higher costs. However, sequentially EBIDTA margins improved by 20 bps. Access Charges and license fees increased by 330 bps y-o-y to 19.6% as a percentage of sales. Network costs decreased by 670 bps y-o-y and by 190 bps q-o-q as a percentage of sales to 25.9%. SG&A cost increased by 410 bps y-o-y and by 110 bps q-o-q to 16.3%. RCom recorded EBIDTA of Rs.1,528.9 cr in Q3FY11.

- RCom's other income rose from Rs.26.2 cr in Q3FY10 to Rs.139.1 cr in Q3FY11. It reported Rs.129.6 cr interest charges (net debt on the up) vis-à-vis Rs.407.5 cr worth interest income in Q3FY10 and Rs.279.7 cr interest charges in Q2FY11. The company has capitalized Rs 1.2bn of interest charges pertaining to 3G debt. Rcom's average borrowing cost (excluding forex fluctuations) has been relatively low at less than 5% due to funding via convertible bonds. (FCCBs) to the tune of ~US$1.2bn that are due for redemption in FY12 & RCom may find it difficult to refinance this outflow at a low cost. Depreciation charges jumped by 24.1% y-o-y due to higher provision in Q3FY11. RCom reported tax reversal of Rs.21.4 cr during the quarter. Lower revenues, higher expenditure and interest charges led to net profit falling sharply by 56.7% y-o-y to Rs.480.3 cr in Q3FY11. However, sequentially net profit rose by 7.7%.

Capex guidance maintained:

- RCom has maintained capex guidance of Rs.3,000 cr excluding of a provision for cash outgo towards the 3G spectrum in FY11. In Q3FY11, RCom incurred capex of Rs.19.1 bn vis-à-vis Rs.9.2 bn in Q2FY11 of which ~65% was for its wireless business.

Other Updates:

- RCom's net debt as of December 2010 stands at Rs.324 bn and cash at Rs.15 bn (vis-à-vis Rs.86.1 bn in Q2FY11).

- Reliance Internet Data Center (RIDC), the IDC division of Reliance Communications has partnered with Microsoft to launch Reliance Hosted Exchange 2010 - a complete end-to-end e-mailing solution which promotes business messaging and collaboration. The Reliance Hosted Exchange 2010 eliminates users' needs to invest in hardware, software licenses, security and related management costs by providing a 'pay-per mailbox' Service model. This offers the customer a cost-efficient enterprise class mailing solution without the hassle of managing the same.

- RCom signed a MoU with China Development Bank Corporation for syndicated loan financing of US$1.93 bn. The proposed facility has 10 year maturity, and will be funded by a Syndicate including CDB and other Chinese Banks / Financial Institutions. RCom will benefit from extension of maturity, and substantial savings in interest costs. The MoU covers the first and largest Syndicated Loan of US$ 1.33 billion for refinancing 3G Spectrum Fees and financing of upto US$600 mn towards 85% of equipment and services to be procured from Huawei and ZTE. This facility is over and above the existing US$750 mn facility, already substantially utilized by RCom for procurement of equipment and services from Huawei and ZTE.

Way forward:

- The management believes that MNP could be a growth driver given its reach in GSM and CDMA and its need based Simply Reliance plan made available to suit all customers. It expects to be in the 3G market on a pan-India basis by end of FY11.

Risks

- Lower than expected subscriber growth or higher than anticipated pressure on realisation rates could impact margins.

- Intense competitive tariffs being offered by late entrants in the industry could be a cause of concern for RCom and put pressure on revenues and profits.

- As 3G spectrum allocations have been done, this has resulted in cash outflow of Rs.8,765 cr and also higher net debt, which stands at Rs.324 bn as on December 30, 2010. RCom needs to soon take steps to deleverage its Balance Sheet.

- Amortisation of 3G licence fees and other initial costs could dent profitably going forward, while revenues therefrom may take time to rise.

Conclusion

RCOM is the only player in the country to provide GSM and CDMA services. Like its peers, RCom reported lacklustre results for Q3FY11. The sector continues to witness a difficult operating environment, with more than 10-12 operators competing in each circle. RCom's performance has been poorer than its peers.

The implementation of mobile number portability (MNP) is likely to prove to be yet another headwind for the sector (though RCom could benefit). As per the management, the two benefits for RCom are it playing a challenger to incumbents and it's a new GSM player in case of 3G services. Going forward, RCom plans to focus on high ARPU segment where the churn rates are low.

Given the expected cost overrun due to 3G launch and stiff competition, we are revising our FY11 estimates downwards. We are also cutting FY12 estimates despite assuming benefits to the topline from MNP and 3G. Concerns on further negative surprises, constant changes in accounting policies/estimates (incl change in depreciation policies and write back of tax), frequent revaluation of assets, weakening balance sheet, higher debt and poor operating matrices could result in the stock continuing to get poor valuation compared to its peers despite the recent improvement in performance. Further its involvement in the 2G spectrum scam could also affect its valuation. There are no near term positive earnings catalysts for the stock. Rcom has not able to post revenue growth for the past two years and witnessed sharply falling profitability. However recent events and poor results have driven the stock price to another extreme. Events (like M&A possibilities, stake sale, tower business spinoff/sale etc) could drive its stock price upwards.

In our earlier report dated November 19, 2010 we had stated that the stock could trade in the band of Rs.131 to Rs.164 for the next few quarter. Post to the issue of the report, the stock touched a low of Rs.89.4 on February 11, 2011 and a high of Rs.151.6 on November 22, 2010. At the CMP, the stock is trading 11.4x FY11RE EPS of Rs.7 and 12.6x FY12RE EPS of Rs.7.4.

We think that the stock could trade in the Rs.81 (11xFY12RE EPS) to Rs.125 (17x FY12RE EPS) band for the next quarter.

Quick Estimates - Consolidated

Particulars (Rs in Crs)	FY09	FY10	FY11 (RE)*	FY11 (RE)*	FY12 (OE)*	FY12 (RE)*
Operating income	22234.6	22250.4	21215.6	20229.6	23842.0	22356.2
PBIDT	8580.9	7887.0	6820.1	6412.8	7872.9	6818.0
PBIDTM (%)	38.6%	35.4%	32.1%	31.7%	33.0%	30.5%
Profit after Tax	5907.5	4704.1	1554.7	1327.1	1692.7	1520.7
PATM (%)	26.6%	21.1%	7.3%	6.6%	7.1%	6.8%
EPS	28.6	22.8	7.5	7.0	8.2	7.4
P/E (x)	3.3	4.1	12.4	13.2	11.4	12.6

* OE = Original Estimates, RE = Revised Estimates (Source: Company, HDFC Sec Estimates)

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