

# Reliance Communications (RCOM IN) Telecom

January 8, 2007

Stock rating: Underperform

Coverage view: Cautious

Price: Rs435

Target price: Rs375

BSE-30: 13,652

## Why read this report?

- Covers key issues—quality of revenues, earnings, balance sheet, accounting
- Evaluates valuation issues in detail—DCF versus relative valuations
- Analyzes wireless outlook, RCL's quality of subs, revenues

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## Kotak Institutional Equities Research

Important disclosures appear at the back of this report.

Boat in high tide. We find RCL stock overvalued despite our strong projected growth in earnings and cash flows over the next few years. High liquidity over the next few months may support the stock price but a potential industry slowdown and more aggressive price competition could turn the tide.

## 12-month DCF-based target price of Rs375; 14% potential downside

The absolute valuation of RCL appears stretched in the absence of aggressive assumptions on subscriber growth, pricing, profitability and compromising on WACC/growth in perpetuity. However, a more aggressive set of assumptions would lead to unrealistic levels of ROAE and ROACE in the later years of our forecast period.

## Earnings to grow strongly led by volume growth

We model RCL's EPS to grow to Rs32.5 in FY2010E from Rs12.5 in FY2007E led by (1) strong growth in wireless subs (70 mn at end-FY2009 from 28.6 mn at end-November 2006) and (2) moderately strong growth in long distance (LD) and broadband segments. RCL's GSM expansion strategy is a big variable for the Indian wireless market and its financials.

## Pricing may be an issue across all segments

We expect pricing to deteriorate in all the key segments of the India telecom sector—wireless, LD and data. In the critical wireless segment, we could see increased price competition as a result of the proliferation of new players in new circles, RCL's GSM expansion, a potential industry slowdown and the eventual introduction of mobile number portability (MNP).

## Key upside risks: Continued high liquidity, better-than-expected margins

Higher-than-expected profitability from weaker-than-expected competition in the Indian wireless market could support valuations of Indian stocks; however, we already model very high profitability and returns for Indian wireless players. Also, continued high liquidity in the Indian market and strong wireless subscriber momentum may sustain valuations.

### Company data and valuation summary

Company data	Stock data	High	Low	Price performance	1M	3M	12M
Rating: Underperform	52-week range (Rs)	489	186.5	Absolute (%)	(2.7)	23.1	75.7
	Yield (%)	-	-	Rel. to BSE-30 (%)	(1.6)	11.5	35.2
Current price (Rs)	Priced at close of: Jan 08, 2007						
435	Capitalization			Forecasts/valuation			
	Market cap (Rs bn)	890		2006	2007E	2008E	
	Net debt/(cash) (Rs mn)	43,174		EPS (Rs)	2.2	12.5	20.8
	Free float (%)	32.8		P/E (X)	200.8	34.8	20.9
	Shares outstanding (mn)	2,045		ROE (%)	8.2	15.3	17.4
				EV/EBITDA (X)	42.0	16.2	12.4

Source: Company data, Kotak Institutional Equities estimates.

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## Table of contents

- 1 **Overview:** Boat in high tide
- 3 **Valuation:** Absolute valuation stretched
- 8 **Wireless segment:** Price versus volume
- 18 **LD segment:** New players may spoil the party
- 22 **Broadband segment:** Exploitation of broad pipes is key
- 25 **Key issues:** Quality of wireless subs, disclosures
- 31 **Financials:** Earnings set to grow strongly
- 39 **Disclosures**

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### Expected news flow/events

<b>Date</b>	<b>Event</b>	<b>Comment</b>
End-January 2006	3QFY07 (December 2006 ending quarter) quarterly results.	Greater visibility on the sustainability of trends in operating margins seen in 1QFY07 and 2QFY07.
January/February 2006	Decision on a potential sale of Hutchison's stake in Hutchison-Essar.	The outcome of a sale, if any, would be critical for the industry; it could determine the level of future competition depending on the new owner (extant operator or new entrant).
February 28, 2006	India budget FY2008.	A possible reduction to license fees on wireless service may boost short-term profitability of all wireless operators.

Source: Kotak Institutional Equities estimates.

*The prices in this report are based on the market close of January 8, 2007.*

## Overview: Boat in high tide

### Exhibit 1: Forecasts and valuation

Year end	Revenues	EBITDA	Net Income	EPS	EV/EBITDA	P/E
March	(Rs mn)	(Rs mn)	(Rs mn)	(Rs)	(x)	(x)
FY2006	106,273	23,341	4,781	2.2	42.0	200.8
FY2007E	150,737	57,838	26,441	12.5	16.2	34.8
FY2008E	207,607	80,512	43,497	20.8	12.4	20.9
FY2009E	266,139	105,029	54,627	26.1	9.5	16.7
FY2010E	318,221	126,567	68,002	32.5	7.7	13.4

Source: Company data, Kotak Institutional Equities estimates.

### Investment overview and valuation: 12-month DCF-based target price of Rs375

**We initiate coverage of RCL stock with an Underperform rating and a 12-month DCF-based target price of Rs375.** Despite our strong projected growth in revenues and earnings for RCL for the next several years, we are unable to justify RCL's current valuation and stock price. At our target price, the stock will trade at 18X FY2008E EPS of Rs20.8 and 14.4X FY2009E EPS of Rs26.1. The valuations may look inexpensive in the context of our strong projected earnings growth. However, we note that Reliance's earnings do not reflect (1) high capex over the next few years, (2) its low taxation (low single digits over next two years, which will likely increase in the future) and (3) low depreciation (due to significantly lower rates versus peers).

We could have made more aggressive assumptions on pricing to increase our valuation but this would push ROAE and ROACE over our 10-year forecast to unrealistic levels. Our earnings model results in 24% average ROAE and 21% ROACE over FY2007-FY2016E. We note RCL's returns could be higher but for its 'large' asset base—low current utilization of certain assets (long distance in particular), possible revaluation of assets in 2QFY07 and low depreciation rates relative to peers. Thus, we find the returns reasonable in the context of a capex-intensive industry and competitive Indian telecom market.

**We do not advocate the use of relative valuations to value RCL stock** as they fail to capture (1) expensive valuation of the entire Indian wireless sector, (2) high recurring capex in the Indian telecom sector compared to certain other high-growth sectors such as IT/ITES and (3) increased tax payment rising to near full tax payment over the next few years, which do not reflect in near-term multiples, based on one-to-two year forward earnings; Indian telecom companies will continue to pay around minimum alternative tax (MAT) rate of 11.22% compared to the normal tax rate of 33.66% over the next 1-3 years.

### Devil's advocate view: Higher-than-expected profitability, high liquidity

**We see two areas of positive surprise, which could sustain RCL's stock price above our fair value.** (1) Benign price competition in the key wireless segment may result in higher-than-expected prices (revenue per minute or RPM) and hence, higher-than-expected profitability. (2) Continued high liquidity in the Indian market may result in the street continuing to focus on relative valuation of RCL versus its key comparable, Bharti Airtel, rather than on the validity of absolute valuations of either stock.

## Financials: Earnings set to grow strongly

**We model RCL's EPS to grow to Rs32.1 in FY2010E from Rs12.4 in FY2007E,** driven by strong growth in wireless subs and moderately strong growth in revenues in LD and broadband segments. We see pricing in the wireless segment as the biggest variable for RCL's earnings (and valuation). We expect pricing to be further constricted by the entry of new players in new circles, RCL's GSM expansion, Bharat Sanchar Nigam's (BSNL) large capacity addition and a potential slowdown in subscriber growth over the next few quarters.

**We expect RCL to generate free cash flow from FY2010E** unless (1) RCL's wireless subscriber additions surprise positively and (2) RCL invests aggressively in fixed-line and retail broadband segments. As a result of free cash flow generation, we model RCL's net debt-equity ratio to decline to 10% at end-FY2010E versus 56% at end-FY2006. Based on improved net income, we forecast RCL's ROAE and ROACE to increase to 23.1% and 17.6% in FY2010E, respectively, from 21.2% and 13.4%, respectively, in FY2007E.

## Company profile

**Reliance Communications, part of the Reliance Anil Dhirubhai Ambani Enterprises group, is India's second-largest wireless operator in terms of subscribers.** It also has strong positions in the long distance (ILD) and broadband segments. RCL has grown its subscriber base and earnings strongly over the past few quarters led by its strong management and solid execution. RCL's strategy to grow revenues and earnings is to expand the reach of its wireless and broadband services and exploit its extant long distance (both national and international) infrastructure.

We expect RCL's expansion strategy in the critical wireless segment to have far-ranging implications for the Indian wireless market. It has announced plans to start a GSM service in 15 additional circles, where it is already present through its CDMA service. RCL probably sees limitations to a CDMA service in the Indian market, which is dominated by GSM. Also, RCL management has expressed interest in acquiring a stake in Hutchison-Essar, India's fourth largest wireless operator and a large GSM operator.

## Valuation: Absolute valuation stretched

Our 12-month DCF-based target price for RCL is Rs375, which implies a 14% potential downside to the stock price. We believe our assumptions are reasonable as they translate into 24% average ROAE and 21% average ROACE over our 10-year forecast period. The key upside risk to our target price is stronger-than-expected profitability.

DCF is the best methodology; DCF valuation is Rs375

Exhibit 2 presents our DCF valuation model for RCL. We use a 12.5% WACC and 5% growth to perpetuity. We find the exit multiple at 6.3X EBITDA (FY2016E) reasonable in the context of current valuations of emerging market wireless stocks (see Exhibit 3) and terminal year capex, EBITDA and cash flows (see Exhibit 4).

### Exhibit 2: Our one-year forward value for RCL stock is Rs375

Discounted cash flow valuation of Reliance Infocomm (Rs mn)

	2007E	2008E	2009E	2010E	2011E	2012E	2013E	2014E	2015E	2016E
<b>EBITDA</b>	<b>57,838</b>	<b>80,512</b>	<b>105,029</b>	<b>126,567</b>	<b>146,919</b>	<b>163,844</b>	<b>177,473</b>	<b>190,111</b>	<b>204,028</b>	<b>217,341</b>
Tax	(2,179)	(2,330)	(7,910)	(9,563)	(11,213)	(12,768)	(14,325)	(15,887)	(39,919)	(55,364)
Change in working capital	33,148	(1,303)	(8,756)	(8,411)	(6,459)	(2,244)	2,805	1,833	1,351	1,322
<b>Post-tax operating cash flow</b>	<b>88,807</b>	<b>76,879</b>	<b>88,363</b>	<b>108,593</b>	<b>129,247</b>	<b>148,832</b>	<b>165,954</b>	<b>176,057</b>	<b>165,461</b>	<b>163,299</b>
Capex	(63,869)	(97,902)	(96,101)	(81,746)	(59,817)	(51,690)	(51,357)	(55,748)	(58,645)	(61,233)
<b>Free cash flow</b>	<b>24,938</b>	<b>(21,022)</b>	<b>(7,738)</b>	<b>26,847</b>	<b>69,430</b>	<b>97,142</b>	<b>114,597</b>	<b>120,309</b>	<b>106,815</b>	<b>102,066</b>
	<b>Now</b>	<b>+ 1-year</b>	<b>+ 2- years</b>							
PV of cash flows	260,205	304,144	405,907							
PV of terminal value	459,001	481,951	506,049							
EV	719,206	786,095	911,956							
Net debt	43,174	20,523	43,163							
<b>Equity value (Rs mn)</b>	<b>676,033</b>	<b>765,572</b>	<b>868,792</b>							
<b>Equity value (US\$ mn)</b>	<b>15,192</b>	<b>17,204</b>	<b>19,523</b>							
RCL shares (mn)	2,045	2,045	2,045							
<b>Equity value (Rs/RCOM share)</b>	<b>331</b>	<b>374</b>	<b>425</b>							
Exit FCF multiple (X)	13.3	13.3	13.3							
<b>Exit EBITDA multiple (X)</b>	<b>6.3</b>	<b>6.3</b>	<b>6.3</b>							
<b>WACC and terminal year assumptions</b>										
Terminal growth (%)	5.0									
WACC (%)	12.5									

Source: Kotak Institutional Equities estimates.

**Exhibit 3: EV/ EBITDA for most mature wireless companies in emerging markets is in the range of 4.5-8X**

Valuation summary of key emerging market wireless companies

Companies	Price (LC)	Market cap (US\$m)	Enterprise Value (US\$ mn)	Sales FY06 (US\$m)	EBITDA Margin (%)	EPS (LC)		P/E (X)		EV/EBITDA (X)	
	Jan 03, 2007					2006E	2007E	2006E	2007E	2006E	2007E
<b>Emerging markets</b>											
AIS	THB 75.0	6,141	6,708	2,565	52.3	5.9	6.4	12.8	11.7	5.1	4.8
CMHK	HK\$ 68.20	174,572	161,774	31,203	57.4	3.3	3.9	20.8	17.7	7.8	7.0
China Unicom	HK\$ 11.60	18,840	21,169	11,176	32.7	0.5	0.5	25.8	22.5	5.3	5.0
Digi.com	Rm 15.90	3,387	3,149	819	44.2	0.9	1.1	17.1	14.3	7.0	6.4
Indosat	Rp6,650.00	4,012	4,942	1,287	56.1	286.3	338.7	23.2	19.6	6.2	5.5
Maxis	Rm 10.40	7,442	7,576	1,809	55.8	0.7	0.7	14.1	14.1	7.2	6.8
TAC	US\$4.3	2,031	2,949	1,170	38.1	0.3	0.4	15.3	10.1	6.1	5.3
Hutchison	HK\$ 18.76	11,454	16,304	3,127	27.0	0.1	0.4	135.0	52.1	12.5	9.7
<b>Average/Total</b>		<b>227,878</b>	<b>224,570</b>	<b>53,155</b>	<b>45.5</b>			<b>33.0</b>	<b>20.3</b>	<b>7.1</b>	<b>6.3</b>
<b>Weighted average</b>					<b>49.5</b>						

Source: Bloomberg.

**Exhibit 4: 6.5X exit EBITDA is reasonable for a stable/mature wireless business**

Illustration of linkage between FCF and EBITDA exit multiples under different scenarios

EBITDA/sales (%)	35	40
Tax/EBITDA (%) (a)	20	20
Capex/sales (%)	12	12
Capex/EBITDA (%)	34	30
FCF/EBITDA (%)	46	50
<b>FCF exit multiple (X) (b)</b>	<b>13.0</b>	<b>13.0</b>
<b>EBITDA exit multiple (X)</b>	<b>5.9</b>	<b>6.5</b>

(a) Based on our actual model estimates for RCL and Bharti.

(b) Derived from WACC and growth to perpetuity assumptions in the terminal year.

Source: Kotak Institutional Equities estimates.

We do not use RCL's reported cash (for calculation of net debt) to compute equity value from enterprise value. We adjust RCL's cash position for (1) payment of disputed claims, (2) decline in creditors to normal levels; trade and capex payables appears to be very high; and (3) likely reduction to advances from customers, which also appears to be very high relative to its revenues and peers. These adjustments to the balance sheet reflect in working capital in our DCF model.

What could close the valuation gap between the stock price and our DCF valuation?

We examine key factors that could close the valuation gap between the current stock price and our DCF valuation.

- 1. More aggressive subscriber (volume forecasts).** Raising our subscriber forecasts for RCL by 20% throughout our forecast period (and leaving ARPU unchanged, a radical assumption) increases our DCF-valuation to Rs460. We note that the impact would be much smaller adjusted for a lower ARPU; higher volume growth will also result in higher capex and opex (network operating costs), which partly negate the impact of higher volumes and revenues.

- 2. More aggressive pricing (profitability) assumptions.** Raising our price assumptions (ARPU or ARPU) by 20% for the wireless segment throughout our forecast period (and leaving subscriber forecasts unchanged) raises our DCF valuation to Rs522. As can be seen, pricing has a more significant impact on valuation than volume; price-led growth has very little cost associated with it, barring statutory (license and spectrum fees) levies in contrast to volume-led growth. However, in this scenario, our terminal year ROACE and 10-year average ROACE (excluding other income and cash) increases to 32.6% and 26.6%, respectively, versus our current forecast of 25.2% and 20.8%, respectively. We doubt the Indian telecom market will be (and should be) this profitable in the long term.
- 3. Lower WACC and higher growth to perpetuity.** Exhibit 5 illustrates the sensitivity of our 12-month forward DCF valuation to different scenarios of WACC and growth to perpetuity. It is possible to have certain combinations of WACC (lower versus base case) and growth in perpetuity (higher versus base case), which can justify RCL's current stock price. However, we note that these combinations result in very high exit EBITDA multiples, which we find tough to justify in the context of steady-state EBITDA, capex and cash flow or in comparison with current multiples of emerging market wireless stocks.

**Exhibit 5: A lower WACC and higher growth in perpetuity will result in higher valuation**  
Sensitivity of RCL's 12-month forward valuation to WACC and growth in perpetuity

Sensitivity of 12-month DCF to WACC and growth in perpetuity						
		Growth in perpetuity (%)				
		4.0	4.5	5.0	5.5	6.0
WACC (%)	10.5	473	501	534	574	623
	11.0	434	457	484	516	555
	11.5	400	420	442	468	499
	12.0	371	387	406	427	453
	12.5	345	359	374	392	413

Sensitivity of exit EV/EBITDA multiple to WACC and growth in perpetuity						
		Growth in perpetuity (%)				
		4.0	4.5	5.0	5.5	6.0
WACC (%)	10.5	7.2	7.8	8.5	9.4	10.4
	11.0	6.7	7.2	7.8	8.5	9.4
	11.5	6.3	6.7	7.2	7.8	8.5
	12.0	5.9	6.3	6.7	7.2	7.8
	12.5	5.5	5.9	6.3	6.7	7.2

Source: Kotak Institutional Equities estimates.

### We see little merit in multiple-based valuations

We do not advocate the use of multiples for valuing Indian telecom stocks for four reasons. We show the valuations of Indian telecom stocks in Exhibit 6 but note that this has limited comparison value and is presented more for the sake of comprehensiveness.

**Exhibit 6: Valuation summary of key Indian telecom companies**

Company	8-Jan-07		Mkt cap		O/S Shares	EPS (Rs)			EPS Growth (%)			PER (X)			EV/EBITDA (X)		
	Price (Rs)	Rating	(Rs mn)	(US\$ mn)	(mn)	2006	2007E	2008E	2006	2007E	2008E	2006	2007E	2008E	2006	2007E	2008E
MTNL	158	U	99,383	2,234	630	6.6	6.8	9.0	(32.1)	2.2	32.6	23.8	23.3	17.6	11.1	8.3	6.4
Bharti Airtel Ltd	621	U	1,179,207	26,502	1,898	10.7	20.9	29.4	n/a	95.4	40.7	58.1	29.8	21.1	29.5	16.9	12.2
Reliance Communication	435	U	890,125	20,005	2,045	2.2	12.4	20.5	n/a	470.4	65.8	200.8	35.2	21.2	40.0	16.0	11.8
VSNL	436	OP	124,203	2,791	285	18.6	15.8	16.6	23.0	(15.4)	5.1	23.4	27.6	26.3	11.2	12.8	11.5
<b>Telecom</b>		<b>Neutral</b>	<b>2,292,918</b>	<b>51,532</b>					<b>55.0</b>	<b>117.3</b>	<b>46.2</b>	<b>66.0</b>	<b>30.4</b>	<b>20.8</b>	<b>28.6</b>	<b>15.8</b>	<b>11.7</b>
<b>KS universe (b)</b>			<b>25,113,522</b>	<b>564,412</b>					<b>18.5</b>	<b>32.7</b>	<b>12.6</b>	<b>23.5</b>	<b>17.7</b>	<b>15.7</b>	<b>13.9</b>	<b>10.4</b>	<b>9.3</b>

Company	EPS 3yr CAGR	EBITDA 3yr CAGR	Sales (Rs mn)			EBITDA (Rs mn)			Net Income (Rs mn)			Net debt (Rs mn)		
	(%)	(%)	2006	2007E	2008E	2006	2007E	2008E	2006	2007E	2008E	2006	2007E	2008E
MTNL	13.8	9.7	54,565	50,299	53,473	7,080	9,473	12,268	3,821	4,267	5,657	(20,584)	(23,829)	(24,092)
Bharti Airtel Ltd	50.6	43.5	116,641	186,421	255,832	41,503	73,322	101,721	20,812	40,617	57,142	44,218	61,830	66,159
Reliance Communication	123.4	61.5	106,273	150,737	207,607	23,341	57,838	80,512	4,820	26,159	42,883	43,174	35,640	58,895
VSNL	(1.8)	2.4	37,810	39,135	43,145	10,093	8,934	9,954	5,313	4,497	4,725	(11,269)	(9,617)	(9,561)
<b>Telecom</b>	<b>32.0</b>	<b>33.3</b>												

Note:

(a) 2003 means calendar year 2002, similarly for 2004 and 2005 for these particular companies.

(b) EV/Sales & EV/EBITDA for KS universe excludes banking sector.

(c) Rupee-US Dollar exchange rate (Rs/US\$) = 44.5

Source: Bloomberg, Company reports, Kotak Institutional Equities estimates.



- 1. Multiples suggest little about absolute valuations of a sector or stocks.** We note that this may be particularly true about the current valuations of the Indian telecom (wireless) sector, where we find the entire sector over-valued on an absolute basis. Thus, benchmarking one stock with the sector average or the sector leader would simply compound the over-valuation or under-valuation, over-valuation in this case. It is difficult to justify the current stock prices of the Indian telecom stocks without very aggressive assumptions in the later years; even with very high levels of profitability and resultant financial returns in the later years of a 10-year explicit model (see Exhibit 7), we are not able to justify the current valuations of Bharti Airtel or RCL.

**Exhibit 7: We model very high returns in the later years of our forecast period**  
Profitability and returns of RCL and Bharti, March fiscal year-ends, 2009-2016E (%)

	2009E	2010E	2011E	2012E	2013E	2014E	2015E	2016E
<b>Reliance Communications</b>								
EBITDA margin	39.5	39.8	40.3	40.8	40.8	40.9	41.2	41.4
ROAE	23.4	23.1	22.9	23.2	24.6	27.4	25.4	25.2
<b>ROACE</b>	<b>16.6</b>	<b>17.6</b>	<b>19.6</b>	<b>22.1</b>	<b>24.6</b>	<b>27.4</b>	<b>25.4</b>	<b>25.2</b>
<b>Bharti Airtel</b>								
EBITDA margin	39.5	40.4	40.9	41.2	41.2	41.2	41.3	41.3
ROAE	34.4	31.6	30.3	29.4	31.5	32.8	35.6	37.3
<b>ROACE</b>	<b>27.9</b>	<b>29.5</b>	<b>30.1</b>	<b>29.2</b>	<b>31.2</b>	<b>32.3</b>	<b>34.9</b>	<b>36.3</b>

Note:

(a) ROAE and ROACE are computed excluding other income from numerator and cash from denominator.

(b) RCL's ROAE and ROACE are depressed by its higher asset base (revaluation and lower depreciation rates).

Source: Kotak Institutional Equities estimates.

- 2. Multiples do not reflect capex-intensity of the telecom business.** We note valuations based on P/E or EV/EBITDA do not capture high capex required in the telecom business relative to other high-growth sectors (IT, ITES). Ideally, the multiples should reflect the capex-intensity of the business but we believe the street has largely ignored this aspect while focusing relatively disproportionately on EPS and EBITDA growth. We believe a cash flow-based valuation will be more appropriate for this business or that other valuation methodologies should reflect the high capex-intensity of the business.
- 3. Multiples do not capture increasing tax payment in the future.** We expect tax payment of Indian wireless companies to increase in the future as they exhaust certain tax benefits available to them. Multiples do not capture this fact as they reflect one or two-year forward earnings when effective tax payment will be low at around MAT rates. However, a DCF-valuation will capture the impact of reduced cash flows from higher tax payment in the future years, when tax benefits diminish. Specifically, we note that RCL will have particularly low effective tax rates over the next two years (low single digits), which boost its net income/EPS.
- 4. Different accounting policies.** We note that different accounting policies, particularly relating to depreciation, will influence net income but not cash flow. Specifically, we highlight that RCL's depreciation policy is less conservative than Bharti's, which boosts its net income/EPS and thus, precludes P/E as a valuation measure, in our view.

## Wireless segment: Price versus volume

RCL's GSM expansion strategy (organic or inorganic) could alter the nature of the wireless business in India with more aggressive price competition (bundling, subsidies); this may have a potential negative impact on currently high industry profitability. We expect lower pricing to partly negate the benefits of our expected strong volume growth for the market and for RCL.

Strong volume growth to drive revenues; pricing may be an issue though

**Exhibit 8 gives key financial and operating parameters of RCL's key wireless segment.** We model RCL's wireless revenues to increase to Rs222 bn in FY2010E from Rs74 bn in FY2006 (12 months ended March 2006)<sup>1</sup> primarily led by an increase in the number of subscribers. We estimate EBITDA to increase to Rs84 bn in FY2010E, from Rs22.3 bn in FY2006. However, we would watch for any potential negative developments in pricing since we are less confident about this variable; also, pricing is much more important for profits and thus valuations compared to volume growth.

### Exhibit 8: We model RCL's wireless revenues to reach Rs222 bn and EBITDA to reach Rs84 bn by FY2010E

Key assumptions for RCL's wireless segment, March fiscal year-ends, 2006-2016E

	2006	2007E	2008E	2009E	2010E	2011E	2012E	2013E	2014E	2015E	2016E
Market subscribers (mn)	90	164	231	297	351	389	421	450	477	503	528
Market penetration (%)	8	14	20	26	30	33	35	37	39	40	42
<b>RCL subs including fixed wireless (mn)</b>	<b>20</b>	<b>35</b>	<b>48</b>	<b>61</b>	<b>70</b>	<b>77</b>	<b>83</b>	<b>88</b>	<b>93</b>	<b>98</b>	<b>103</b>
RCL market share (%)	23	21	21	20	20	20	20	20	20	20	19
Market revenues (Rs bn)	366	534	760	976	1,189	1,346	1,468	1,583	1,693	1,802	1,908
<b>RCL's revenues (Rs bn)</b>	<b>74</b>	<b>109</b>	<b>152</b>	<b>189</b>	<b>222</b>	<b>251</b>	<b>274</b>	<b>294</b>	<b>314</b>	<b>333</b>	<b>352</b>
RCL's market share (%)	20	20	20	19	19	19	19	19	19	18	18
RCL blended ARPU (Rs/month)	385	332	306	290	283	283	284	285	287	290	292
RCL blended MOU (mins/month)	531	436	429	426	426	431	434	437	441	444	448
RCL blended RPM (Rs) (ARPU/MOU)	0.7	0.8	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.7
<b>RCL overall RPM (Rs/min)</b>	<b>1.0</b>	<b>1.0</b>	<b>0.9</b>	<b>0.9</b>	<b>0.8</b>	<b>0.8</b>	<b>0.8</b>	<b>0.8</b>	<b>0.8</b>	<b>0.8</b>	<b>0.8</b>
EBITDA (Rs bn)	22	40	56	70	84	96	106	115	123	133	142
Blended EBITDA per min (Rs)	0.31	0.38	0.35	0.32	0.32	0.32	0.32	0.32	0.32	0.32	0.32
EBITDA margin (%)	30	37	37	37	38	38	39	39	39	40	40

Source: Kotak Institutional Equities estimates.

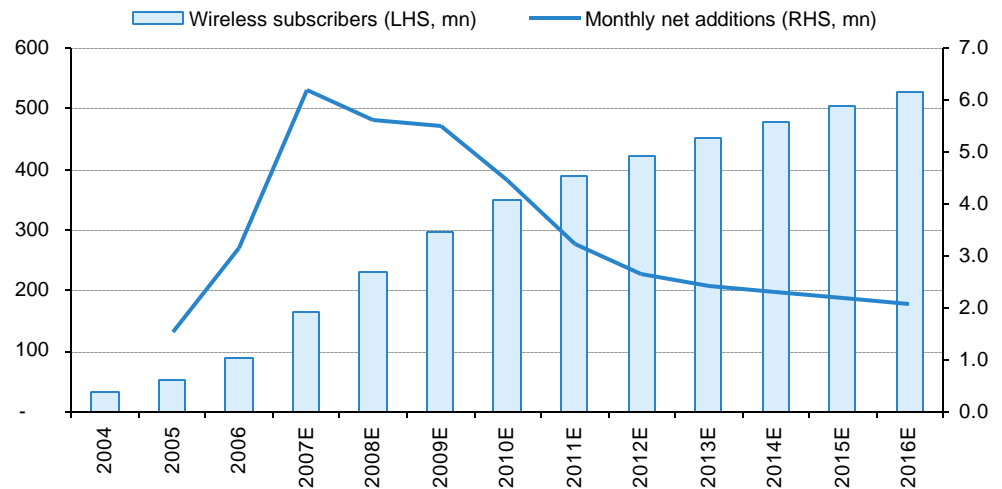
**We expect RCL's revenue growth to lag peer group (despite strong subscriber growth) because we expect revenues from PCOs to grow at a lower-than-market growth rates.** We estimate that PCO revenues contribute to about 15-20% of RCL's wireless revenues; we believe it is unlikely that RCL's PCO revenues will grow at the same rate as normal wireless revenues. In fact, we would be wary about a decline in PCO revenues longer-term as wireless penetration increases; this may result in current PCO users taking a wireless service and not necessarily that of RCL.

<sup>1</sup> We use the conventional financial year for ease of comparison across companies and reporting periods (years). RCL's current reporting period (fiscal year) corresponds to the period January 1, 2006 to March 31, 2007 but future reporting periods would correspond to the standard April to March period (fiscal year).

## Volume: 350 mn total subs by March 2010; 70 mn subs for RCL

**Exhibit 9 shows our forecasts for wireless subscribers in India.** We model India's wireless subscriber base to increase to 351 mn by March 2010 (31% penetration) and 503 mn (40% penetration) by March 2015 from 136 mn at end-November 2006. Rising income levels and falling handset costs and monthly subscriber fees will continue to propel wireless penetration in India.

**Exhibit 9: We forecast 350 mn wireless subscribers in India by March 2010**  
Estimation of wireless subs and net monthly additions, March fiscal year-ends ('000)



Source: Kotak Institutional Equities estimates.

### Wireless coverage and penetration may be reaching 'inflection' levels

**We expect monthly subscriber net additions to decelerate over the next few quarters** because wireless penetration seems to have reached reasonably high levels in the wireless covered areas (see Exhibit 10). We clarify that a portion of the current wireless subscribers may be from rural areas; Bharti had wireless coverage in 155,076 non-census towns and villages as of September 2006 in addition to 4,357 towns. However, even excluding a certain portion of subscribers from rural areas (say 20% of total), we find the penetration remarkably high at 37%. We note that penetration in the cities of Delhi and Chennai is above 50% at present.

**Exhibit 10: Wireless footprint already covers the bulk of urban population**

Estimation of urban wireless penetration in towns already covered by operators

Total urban population, March 2001 (mn)	285
Population in top 4,400 towns, March 2001(mn)	276
Estimated urban population, November 2006 (mn)	305
Estimated population in top 4,400 towns, November 2006 (mn) (a)	295
<b>Share of urban population in top 4,400 towns (%)</b>	<b>97</b>
Wireless subs as of end-November 2006 (mn)	136
<b>Penetration in towns with wireless service (%) (b)</b>	<b>46</b>
<b>Penetration in towns with wireless service (%) (c)</b>	<b>37</b>
Coverage of Bharti based on 4,357 towns and 155,076 villages (%)	50
Coverage of Bharti based on 4,357 towns and 155,076 villages (mn)	563
<b>Penetration in towns and villages with wireless service (%)</b>	<b>24</b>

Note:

(a) Using same proportion as in March 2001.

(b) Assuming all the wireless subs are from the 4,400 wireless covered towns.

(c) Assuming 80% of wireless subs come from the urban areas.

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Source: Census of India-2001, Kotak Institutional Equities estimates.

**RCL—a bigger GSM footprint may impact volume less, pricing more**

**Exhibit 11 gives our forecasts of wireless subscribers of RCL and other key players over the next few years. For the purpose of our modeling, we have assumed RCL remains as it is,** continuing to operate CDMA service in its 15 ‘CDMA only’ circles and CDMA and GSM services in the eight common circles. At this juncture, it is difficult to factor RCL’s GSM expansion plans given uncertainty on (1) timing of receipt of additional spectrum, (2) amount of spectrum, which in turn will influence capex, (3) mode of expansion (organic or acquisition) and (4) execution (rollout of GSM service, pricing strategy) even if spectrum is available.

**Exhibit 11: We model RCL's wireless subs to double between end-FY2007 and end-FY2010**

India wireless subscribers, March fiscal year-ends, 2006-2016E

	2006	2007E	2008E	2009E	2010E	2011E	2012E	2013E	2014E	2015E	2016E
<b>All India</b>											
<b>Wireless subs (mn)</b>	<b>90</b>	<b>164</b>	<b>231</b>	<b>297</b>	<b>351</b>	<b>389</b>	<b>421</b>	<b>450</b>	<b>477</b>	<b>503</b>	<b>528</b>
Monthly net adds ('000)	3,160	6,186	5,617	5,478	4,475	3,217	2,642	2,408	2,288	2,173	2,064
<b>Penetration (%)</b>	<b>8.0</b>	<b>14.5</b>	<b>20.1</b>	<b>25.5</b>	<b>29.7</b>	<b>32.6</b>	<b>34.8</b>	<b>36.7</b>	<b>38.5</b>	<b>40.2</b>	<b>41.7</b>
Population (mn)	1,115	1,131	1,148	1,164	1,180	1,195	1,210	1,225	1,239	1,252	1,265
<b>Market shares (mn subs)</b>											
Bharti Airtel	20	37	51	64	74	81	87	93	98	103	108
<b>Reliance Communications</b>	<b>17</b>	<b>35</b>	<b>48</b>	<b>61</b>	<b>70</b>	<b>77</b>	<b>83</b>	<b>88</b>	<b>93</b>	<b>98</b>	<b>103</b>
BSNL	17	28	40	51	60	66	71	76	81	85	89
Hutchison-Essar	15	26	36	46	54	60	65	69	74	78	81
IDEA Cellular	7	14	21	29	35	40	44	48	51	55	58
TATA Teleservices	5	12	20	28	34	39	43	46	49	52	55
Others	8	12	15	19	22	25	27	29	31	32	34
<b>Total</b>	<b>90</b>	<b>164</b>	<b>231</b>	<b>297</b>	<b>351</b>	<b>389</b>	<b>421</b>	<b>450</b>	<b>477</b>	<b>503</b>	<b>528</b>
<b>Market shares (%)</b>											
Bharti Airtel	21.8	22.3	21.9	21.4	21.1	20.9	20.8	20.7	20.6	20.5	20.4
Reliance Communications	19.3	21.2	20.8	20.4	20.1	19.9	19.8	19.7	19.6	19.5	19.4
BSNL	19.1	17.1	17.3	17.2	17.1	17.0	17.0	16.9	16.9	16.9	16.9
Hutchison-Essar	17.1	16.1	15.7	15.6	15.5	15.5	15.5	15.4	15.4	15.4	15.4
IDEA Cellular	8.2	8.6	9.0	9.6	10.0	10.3	10.5	10.7	10.8	10.9	11.0
TATA Teleservices	5.4	7.4	8.7	9.4	9.8	10.0	10.1	10.2	10.3	10.4	10.5
Others	8.9	7.2	6.6	6.5	6.4	6.4	6.4	6.4	6.4	6.4	6.4
<b>Total</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>

Note:

(a) RCL's wireless subs include fixed wireless subs; however, for TTSL, wireless subs exclude fixed-wireless subs.

Source: Companies, Kotak Institutional Equities estimates.

**We expect our forecasts for RCL's subscribers to be largely neutral to its choice of future technology platform(s).** RCL's subscriber growth will depend on the growth of the market, number of players, RCL's execution and pricing strategy relative to competition; it would depend less on the underlying technology. However, GSM technology may place it on a similar footing with its key competitors in terms of handset choice and roaming.

RCL's capex in the two scenarios (CDMA dominance or GSM dominance) may not be too different. In case of GSM expansion in circles where RCL is present through CDMA, it can utilize its extant passive infrastructure, which could potentially result in lower capex. On the other hand, RCL will probably have lower capex in case of CDMA expansion with few cell sites required compared to GSM. RCL will embark on its GSM program once it receives the license and spectrum to do so. It will start GSM operations in 15 circles; already, it has a presence in eight currently—although these eight are primarily 'B' and 'C' circles.

RCL will likely change the game in its quest for market leadership

**We expect RCL's GSM expansion (when it receives additional spectrum) or acquisition of a large extant GSM operator to be more relevant for pricing.** We expect RCL's GSM expansion to lead to more price competition; price competition has been rather benign over the past few quarters. We believe RCL will likely change the nature of wireless business in India, whether it is able to make a successful acquisition or not.

1. **Leverage vast experience of bundling handsets with CDMA service to GSM service also.** We expect RCL to aggressively bundle handsets with GSM service, as and when it starts GSM service in new circles. GSM service in India has been largely devoid of handset subsidies although operators have periodically bundled handsets with service (with free minutes) through special promotion schemes. It is possible that RCL may initiate a full-fledged subsidy on handsets although it will have to devise a suitable strategy for customer retention. We note that, in any case, RCL incurs some amount of subsidy on its CDMA service and it may choose to extend the practice to GSM service also. If RCL opts for bundling (and moderate handset subsidy) in order to drive volume growth, we believe other operators would have to respond similarly.
2. **Leverage its large distribution network.** RCL can leverage its captive distribution network comprising 1,650 Reliance World stores (owned and operated by RCL) in 700 cities to distribute GSM handsets and service as well. These stores sell CDMA phones and service. The retail stores of GSM operators primarily provide new subscriptions and do not typically sell handsets.
3. **An acquisition, if successful, may hasten the process.** RCL management has expressed its interest to bid for Hutchison Telecommunications International Ltd.'s (HTIL) 52% stake in Hutchison-Essar. We see a potential acquisition by RCL facing several issues given (1) RCL will necessarily have to merge Hutchison-Essar with itself given certain restrictive licensing conditions; an operator cannot have more than 10% stake in two entities in the same circles. A merger would raise issues about Essar's response; (2) RCL may have to acquire Hutchison's (and possibly Essar's) stake for cash; we think Hutchison is unlikely to accept RCL's stock if it wants to exit the Indian telecom market; (3) Essar purportedly has right of first refusal and may choose to exercise it; (4) RCL may have to partly surrender spectrum in certain circles; current licensing conditions do not allow an operator to own more than 15 MHz of spectrum in a circle although this may be relaxed in the future; Hutchison-Essar has 12.4-15 MHz (the maximum stipulated) of spectrum in several circles; and (5) other extant and new operators may also bid, which may push up the purchase price.

The quest for Hutchison-Essar: Large implications for RCL and sector

**The outcome of bidding for Hutchison's stake in Hutchison-Essar may have large implications for RCL and the Indian wireless sector.** We note that the most favorable scenario for the market of an extant telecom operator acquiring Hutchison's stake is also the most difficult due to licensing and spectrum issues highlighted above. We discuss various scenarios, in order of impact on the Indian wireless market—from the most favorable to the least.

- 1. Extant Indian operator acquires Hutchison's 52% stake; Essar remains or exits are sub-scenarios.** This may be the most favorable scenario but may be constrained by licensing, consideration and ownership issues. An acquirer would have to necessarily merge the two entities (acquiring company, say RCL and Hutchison-Essar) to meet the 10% licensing condition. Also, we believe the acquirer may have to pay cash to Hutchison for its 52% stake and to Essar, possibly, for its 33% stake; however, we do not rule out stock payment. Essar's response in this case would be critical; we are not sure Essar would want to play a diminished role in a larger entity though it could choose to do so. However, if it chooses to exit (along with Hutchison), then the acquirer would have to pay cash (or stock) for 100% of Hutchison-Essar. We suspect a cash acquisition would strain the acquirer's balance sheet.
- 2. Essar acquires partner's stake alone or with private equity investors.** This would leave the industry structure practically unchanged. We note that Hutchison-Essar has been a disciplined price operator; the behavior of the entity under the new owner(s)/management would be critical from a competition perspective.
- 3. Extant operator acquires along with private equity investors; Essar remains or exits.** This is akin to Scenario 1 with the only difference being that the extant operator can keep its effective stake below 10% in Hutchison-Essar. However, this is unlikely to lead to consolidation and may not be a good solution for an extant operator; it is unlikely to have much say in the new consortium 'X'-Essar. Also, there may be confusion about the management of the company (acquiring consortium, Essar, private equity investors, telecom operator part of the consortium). Even if the telecom operator in the consortium exercises control (post Essar's exit), the government may not allow indirect control on two 'competing' entities by the same telecom operator.
- 4. Private equity investors acquire the stake.** This may keep the number of operators in the Indian market constant. However, we believe retention of Hutchison-Essar's extant management and Essar's equation with private equity investors would be critical in this case.
- 5. Foreign telecom operator acquires Hutchison's stake.** This will likely fragment the market while increasing competition. Extant foreign telecom operators in India are marginal players in the market at present (Maxis, Telekom Malaysia) or shareholders in Bharti Airtel (Sing Tel, Vodafone). A new foreign telecom company, Maxis, Telekom Malaysia or Vodafone acquiring stakes will likely fragment the market. Vodafone has publicly stated its interest in acquiring Hutchison's stake; we believe it will have to sell its 10% stake in Bharti if it is successful in acquiring Hutchison-Essar.

### Pricing: Expect further deterioration

**We expect the pricing environment to deteriorate in India over the next few quarters for several reasons discussed below.** We believe the pricing environment has been relatively benign over the past year with competition largely showing in the form of increased MOU and capex rather than as pressure on pricing (lower tariffs) and costs (higher SG&A including advertising, handset subsidies and other forms of SAC).

We note that two of the bigger players (and potential price leaders) have had specific problems—(1) BSNL has added capacity sporadically, ruling it out as effective competition despite its more aggressive tariff plans; (2) Reliance has had to operate under the constraints of a weaker CDMA platform (handset issues and roaming limitations), which has prevented it from providing strong competition to GSM operators. During this period, private GSM operators have been relatively immune to price competition due to aforementioned issues at BSNL and RCL; there is very little price competition between private GSM operators, in our view.

- 1. Expansion by operators into ‘new’ circles.** Operators such as Aircel (Maxis), Hutchison-Essar, IDEA Cellular and Spice Telecom (Telekom Malaysia) have sought additional licenses or received letters of intent for new licenses in new circles (see Exhibit 12). Availability of spectrum is an issue currently but we note that the current amount of spectrum can accommodate one more player in the ‘B’ circles, which have five players currently compared to six in metros and ‘A’ circles. Similarly, the ‘C’ circles can see two more players as most of the circles have four players currently. In any case, over the next 9-12 months, we expect additional spectrum to be available, which will facilitate the entry of 2-3 new players in each of the 23 circles.

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**Exhibit 12: Every operator has big plans for expansion**

Status of expansion plans of operators, # of circles

	Current presence	LOI received	Licenses applied	Total
Aircel (Maxis)	9	3	8	20
Hutchison-Essar	16	6		22
Idea Cellular	11	2	10	23
Reliance Communications (GSM)	23 (CDMA) + 8 (GSM)		15	23
Spice Telecom (Telekom Malaysia)	2		21	23

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Source: Companies, compiled by Kotak Institutional Equities.

- 2. GSM foray of RCL may result in more competition among private GSM operators.** As discussed above, we expect RCL to be more aggressive compared to other private GSM operators, which have historically cooperated on pricing rather than competed, in our view.
- 3. BSNL’s expansion may lead to surplus capacity and pressure on pricing.** BSNL will roll out 63.5 mn additional lines in its 23 circles by early FY2008 and we expect it to compete aggressively on pricing; Exhibits 13 and 14 show that BSNL’s tariffs are already very competitive. BSNL’s tender has been delayed as Motorola has sought legal recourse for its disqualification from the tender. BSNL has short-listed Ericsson and Nokia for 45.5 mn lines (North, South and West zones) and has nominated Alcatel-ITI for the balance 18 mn (East zone).



**Exhibit 13: BSNL offers the lowest wireless tariffs in the country**

Comparison of Bharti's prepaid tariffs with that of rival operators

	Bharti (a)	Reliance	BSNL	TTSL	Difference (%)	
					Bharti vs	BSNL vs
					RCL	RCL
<b>Prepaid refill denomination</b>	<b>353</b>	<b>350</b>	<b>337</b>	<b>330</b>		
Service tax @ 12.24%	39	38	37	36		
Fixed (processing) charges	133	150	125	—		
Migration to 15 paise plan (b)	49	NA	NA	NA		
<b>Talktime value</b>	<b>133</b>	<b>162</b>	<b>175</b>	<b>294</b>	<b>(18)</b>	<b>8</b>
<b>Local tariffs (Rs/min)</b>						
M2M (on-net)	0.15	0.99	0.90	1.00	(85)	(9)
M2M (off-net)	2.25	1.99	1.20	2.00	13	(40)
M2F	2.25	1.99	1.20	2.00	13	(40)
<b>DLD tariffs (Rs/min)</b>						
M2M (on-net)	2.00	2.00	2.00	3.00	0	0
M2M (off-net)	2.65	2.5	2.40	3.00	6	(4)
M2F (intra-circle)	2.65	2	1.20	3.00	33	(40)
M2F (inter-circle)	2.65	2.5	2.40	3.00	6	(4)
<b>Billing pulse (seconds)</b>	<b>60</b>	<b>60</b>	<b>60</b>	<b>60</b>	—	—

Notes:

(a) Average of prepaid tariffs in Bharti's top six circles.

(b) Calculation assumes one recharge per month; Rs0.15/min plan has an additional charge of Rs 49 per month.

Source: Companies, compiled by Kotak Institutional Equities.

**Exhibit 14: BSNL's tariffs are the most attractive**

Comparison of estimated prepaid voice revenue/min for leading wireless operators (Rs)

	Reliance	BSNL	Bharti (a)	TTSL
Refill amount	337	337	353	330
Service tax @ 12%	37	37	39	36
<b>Outgoing ARPU</b>	<b>300</b>	<b>300</b>	<b>315</b>	<b>294</b>
Fixed (processing) charges	151	125	133	—
<b>Maximum talk value</b>	<b>149</b>	<b>175</b>	<b>182</b>	<b>294</b>
<b>Blended average tariffs (Rs/min)</b>	<b>1.70</b>	<b>1.16</b>	<b>2.04</b>	<b>1.95</b>
Local 'on-net' tariff	20%	0.99	0.90	1.00
Local 'off-net' tariff (b)	65%	1.79	1.05	2.25
Average DLD tariff (c)	15%	2.25	2.00	2.49
<b>Billing pulse (sec)</b>	<b>60</b>	<b>60</b>	<b>60</b>	<b>1</b>
Effective tariff (Rs/min) (d)	1.87	1.28	2.24	1.95
<b>Outgoing MOU (mins)</b>	<b>80</b>	<b>137</b>	<b>81</b>	<b>151</b>
Share of outgoing MOUs (%)	32	45	28	50
<b>Total MOU (mins)</b>	<b>249</b>	<b>304</b>	<b>290</b>	<b>302</b>
Termination revenues (e)	41	40	50	36
<b>Gross ARPU (Rs/month)</b>	<b>341</b>	<b>340</b>	<b>365</b>	<b>330</b>
<b>Revenue per minute (RPM)</b>	<b>1.37</b>	<b>1.12</b>	<b>1.26</b>	<b>1.10</b>

Notes:

(a) Average of prepaid tariffs in Bharti's top six circles.

(b) Assuming 50:50 ratio of local M2M and M2F calls.

(c) Assuming a uniform distribution of DLD calls across various categories.

(d) Effective tariff assumed 10% higher than the average rate due to a 60-second billing pulse.

(e) Assuming 80% of incoming calls are off-network calls, which result in a termination charge of Rs0.30/min.

Source: Companies, Kotak Institutional Equities estimates.

- 4. Decline in mobile roaming tariffs.** As a result of the regulator's recent recommendation on mobile roaming ceiling tariffs (see Exhibit 15), tariffs may fall by about Rs2/min for calls and by Rs2.5-3 for SMS. The regulator has also recommended removal of (1) 15% surcharge on roaming tariffs applicable currently and (2) monthly rentals for roaming service; all roaming tariff (calls) would be on a per minute basis. The regulator intends to implement the new tariffs by 4QFY07. We expect a bigger impact on private GSM operators who have relatively higher roaming tariffs compared to RCL and BSNL.

**Exhibit 15: The regulator's recent proposal on mobile tariffs will likely lead to a steep fall in domestic roaming tariffs**  
Key proposals of TRAI on domestic roaming tariffs

	Proposed					Current (Rs/min)
	Origination	Carriage	Termination	ADC	Roaming (a)	
<b>Proposal 1 (Cost of service based)</b>						
Incoming call while roaming--Local		✓	✓	✓	✓	3.60
Incoming call while roaming--Inter-circle		✓	✓	✓	✓	3.60
Outgoing call while roaming--Local	✓		✓	✓	✓	2.99
Outgoing call while roaming--Inter-circle	✓	✓	✓	✓	✓	3.60
SMS					Home tariff plan	3.45
<b>Proposal 2 (Home pricing rule)</b>						
Incoming call while roaming--Local	NC	NC	NC	NC	NC	3.60
Incoming call while roaming--Inter-circle	NC	NC	NC	NC	NC	3.60
Outgoing call while roaming--Local	Home tariff plan					2.99
Outgoing call while roaming--Inter-circle	Home tariff plan					3.60
SMS					Home tariff plan	3.45

(a) Incremental cost of roaming is Rs0.25/min versus Rs3/min currently.

(b) ✓ depicts this element can be charged from a customer while roaming.

(c) NC = No charge, since incoming is free in India due to CPP regime.

Source: Telecom Regulatory Authority of India (TRAI), compiled by Kotak Institutional Equities estimates.

- 5. Introduction of mobile number portability (MNP).** We believe that the eventual implementation of MNP will further spice up competition, especially if it is introduced concurrently with the above-mentioned events. The Department of Telecommunications (DOT) has declined to implement the recommendation of the regulator for introduction of MNP from April 1, 2007. Nonetheless, we believe MNP is inevitable over the next few years.

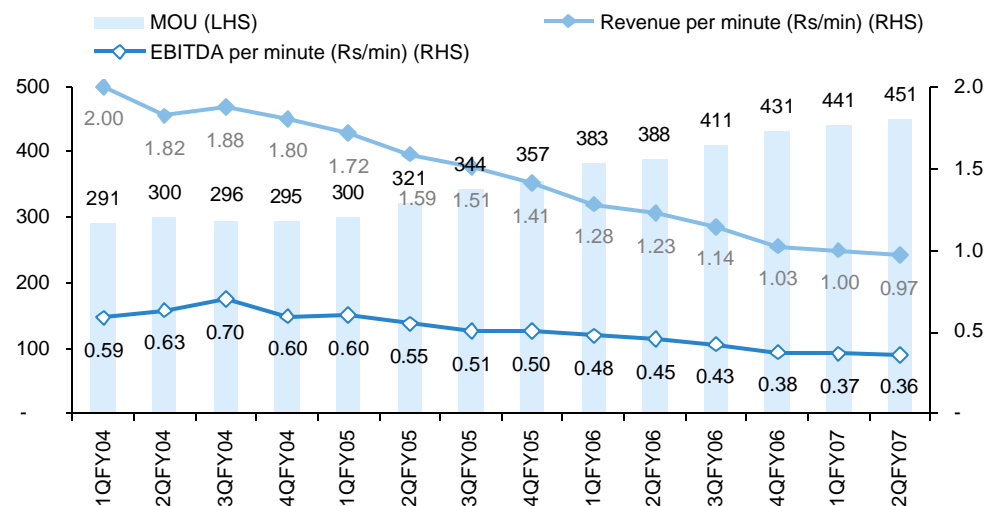
MNP would result in increased churn among subscribers. However, RCL will likely be a key beneficiary of the introduction of MNP and this may be one of the key reasons for its GSM foray. A GSM platform and MNP regime would enable it to attract high-end postpaid subscribers of other GSM operators. It cannot do so currently given certain limitations of CDMA—limited roaming and handset choice.

Reduction to license fee may provide relief in the short-term; competition may erode the benefits longer-term

**A reduction to license fees (% of AGR) would be positive for earnings of the wireless companies including RCL in the short-term, assuming operators can maintain stable tariffs.** However, we expect competition to erode the benefits eventually, especially as competition in India is set to increase significantly, as discussed above. Exhibit 16 shows that tariffs (RPM) have fallen over the past several quarters highlighting that competition has eroded the benefits of lower costs from rising economies of scale or benefits from reduction to license fees (also reduced previously in February 2005). More important, EPM (EBITDA/min) has also declined, which depicts the reduction in profitability more vividly; we attribute the decline in EPM to lower capex costs.

**Exhibit 16: Bharti's profitability/min continues to decline due to moderate pressure on pricing and steep increase in MOUs**

Bharti's wireless revenues and EBITDA on a per minute basis (Rs/min)



Source: Bharti Airtel, Kotak Institutional Equities estimates.

**The government (finance ministry) may accept the recommendation of the Department of Telecommunications (DOT) and the regulator to reduce license fees** (to a uniform 6% of AGR from the current, 6%, 8% and 10% for different circles) on wireless revenues. The regulator and DOT had made the recommendation several months ago; however, the finance ministry is yet to act on it given a potential large negative impact on government revenues and fiscal deficit. We would watch for a reduction in the FY2008 budget due February 28, 2007; a large increase in wireless revenues may permit the finance ministry to reduce license fees.

## LD segment: New players may spoil the party

We expect the imminent entry of several new players in the ILD and DLD segments to likely result in further declines in LD tariffs and lower carriage charges (net revenue/minute) for RCL and other LD operators. Nonetheless, RCL has a strong position with its large infrastructure (international and domestic), global reach and a captive wireless subscriber base in India.

Same story as wireless—strong growth in volumes, strong decline in prices

Exhibit 17 shows our estimated revenues and EBITDA for RCL's LD segment over the next few years and also gives key assumptions behind our model for RCL's LD segment broken down between the ILD and DLD segments. The performance of this segment will likely be intricately linked with the performance of RCL's wireless segment because we expect the major players to become integrated operators with their own DLD/ILD operations. Thus, barring incoming ILD revenues, we expect other LD revenues to largely reflect captive volumes of an operator. Accordingly, RCL's GSM expansion is critical for its LD segment also.

### Exhibit 17: We model RCL's LD revenues to increase to Rs102 bn and EBITDA to Rs27 bn by FY2010E

Key assumptions for RCL's wireless segment, March fiscal year-ends, 2006-2016E

	2006	2007E	2008E	2009E	2010E	2011E	2012E	2013E	2014E	2015E	2016E
<b>LD revenues (Rs bn)</b>	52	56	71	87	102	118	130	139	147	156	165
<b>LD EBITDA (Rs bn)</b>	6	14	19	23	27	32	35	38	40	42	45
<b>EBITDA margin (%)</b>	12	25	27	26	26	27	27	27	27	27	27
<b>Domestic long distance</b>											
Market revenues (Rs bn)	103	108	129	156	176	193	208	222	236	250	263
Revenues to DLD operator (net of orig.)	62	70	81	92	99	107	115	124	133	142	151
RCL's revenues (Rs bn)	12	13	19	22	24	26	28	30	32	33	35
RCL's market share (%)	19	18	23	24	24	25	24	24	24	24	23
<b>International long distance</b>											
Market revenues (Rs bn)	66	56	63	73	84	95	107	116	127	138	150
RCL's IDD revenue (Rs bn)	19	16	18	20	22	24	27	30	32	35	38
RCL's market share (%)	28	29	28	27	26	25	26	25	25	25	25
Market minutes (bn mins)	11	15	19	23	28	31	36	39	42	46	50
RCL's share of mins (%)	40	36	35	33	31	30	29	29	29	29	29

Source: Kotak Institutional Equities estimates.

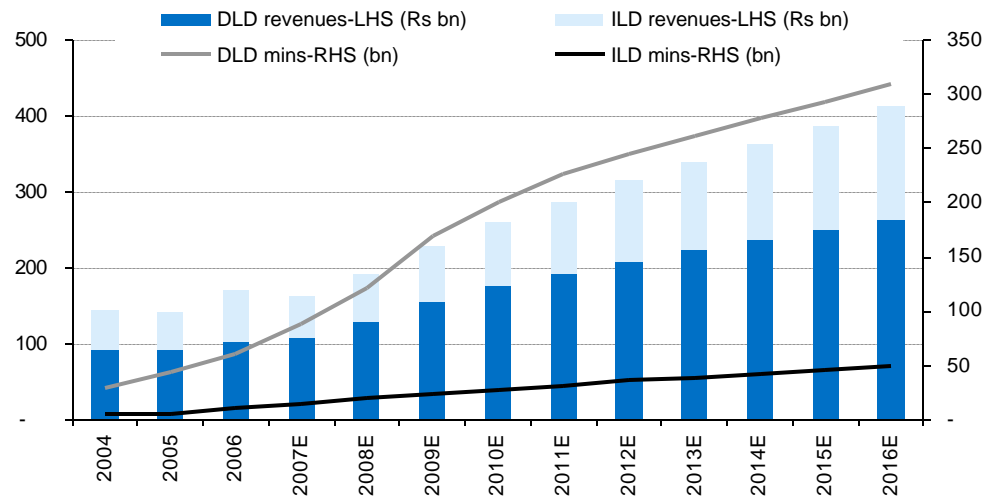
Voice: Price decline to continue

ILD—strong volume growth but pricing to decline sharply

We expect ILD volumes to increase rapidly driven by falling tariffs and strong GDP growth (see Exhibit 18). However, we expect prices (outgoing tariffs and incoming settlement rates) to decline rapidly led by entry of new players in the market. Also, the entry of new players will likely result in market share loss for RCL as also for Bharti and VSNL in the profitable ILD segment; currently, the ILD market is dominated by these players.

**Exhibit 18: We model LD revenues and volumes in India to grow strongly over the next few years**

LD revenues and volumes broken down by DLD and ILD segments, March fiscal year-ends, 2004-2016E



Source: Kotak Institutional Equities estimates.

### RCL has a strong position currently but market share erosion likely

We believe RCL may be better placed versus new competition for reasons highlighted below.

- 1. Ownership of access infrastructure.** RCL owns 100% of FLAG Telecom, which has a 65,000 route km submarine cable system; in September 2006, it commissioned FALCON, an 11,600 route km submarine cable system connecting Europe, North Africa, Middle-East (12 countries) and Asia (including India). RCL also recently announced a next generation network comprising four systems of 50,000 km length at a cost of US\$1.5 bn. It expects to complete the new system over the next three years.
- 2. Large wireless subscriber base in India for outgoing volumes.** RCL's growing wireless subscriber base will provide it with large captive volumes of ILD minutes. Additionally, if RCL is successful in acquiring Hutchison-Essar, its outgoing ILD volumes will likely explode. Hutchison-Essar has a disproportionately high number of high-end subscribers with high likely ILD usage.
- 3. Strong position in incoming ILD market due to extensive customer reach.** RCL has a strong position in countries with a large population of people of Indian origin. Its Reliance IndiaCall service has 0.8 mn subscribes (end-September 2006 data) and as per RCL, this service accounts for 40% of all retail calls to India from the USA. However, we note that other operators like Bharti Airtel have also started this service.

DLD—new players to result in lower carriage charges, commoditization

**We expect DLD to become a complete commodity business within the next few years with distance-neutral tariffs becoming the norm; carriage charges will likely come off significantly as overall DLD tariffs decline and converge to local call levels.** This trend has already started in certain cases in the fixed-line and fixed-wireless segments. Also, we expect captive volumes to dominate DLD volumes for operators as almost all large operators have or will have a DLD presence. Even pure wireless operators such as Hutchison-Essar and IDEA Cellular have taken DLD licenses.

We believe the current ceiling carriage charge of Rs0.65/min and average charge of Rs0.45/min (our estimate) are unsustainable as we expect wireless DLD tariffs to decline from current levels. Also, we believe the LD business is very profitable (in terms of both margins and returns) in India, which implies significant scope for reduction to carriage charges. Although the computation in Exhibit 19 is for the entire LD segment, we believe the DLD segment is more profitable versus ILD segment.

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**Exhibit 19: The LD business in India appears to be very remunerative**

Profitability and CROCI of LD segment of Bharti and Reliance based on 1HFY07 data (Rs mn)

	<b>Bharti</b>	<b>Reliance</b>
Revenues	15,426	25,498
EBITDA	6,117	6,041
<b>EBITDA margin (%)</b>	<b>39.7</b>	<b>23.7</b>
EBIT	5,141	3,339
EBIT*(1-t)	4,570	3,250
Add: Depreciation	976	2,702
Cash return	5,546	5,952
Annualized cash return	11,093	11,904
Gross cash invested	32,563	83,820
<b>CROCI (%)</b>	<b>34.1</b>	<b>14.2</b>

Note:

- (a) Reliance's relatively lower CROCI reflects its excessive investment in the LD segment.
- (b) Reliance's relatively lower margin reflects high amount of low-margin wholesale (FLAG) revenues.
- (c) Breakdown for voice and data is not available but voice also has to be very profitable.

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Source: Kotak Institutional Equities estimates.

RCL can sell its surplus capacity to generate additional revenues

**We see the entry of new players in the DLD segment as an opportunity for RCL to lease/sell its excess bandwidth capacity** and generate revenues from the same through IRUs/lease. We believe the price decline is almost inevitable given the entry of several new players in the DLD segment. Also, there are other operators (both access and infrastructure providers) with a large amount of bandwidth capacity who will sell capacity to the new entrants.

## Data—commodity business

Based on our estimates for RCL's data segment for FY2006 (taking out estimated voice revenues from total LD revenues), we have applied certain growth rates to forecast future revenues. It is difficult to model the data business explicitly given RCL (as is the case with other companies) does not disclose data revenues or composition. In general, we expect volumes to increase strongly while pricing will likely come off significantly. The bulk of data business is a pure commodity business and the start of new submarine cable systems, easy expansion in new systems (for example, FALCON's initial lit capacity is only 90 gbps compared to its design capacity of 2.56 tbps) and opening up of cable landing stations will likely continue to pressure pricing. Exhibit 20 gives details of major cable systems connecting India with the rest of the world.

### Exhibit 20: RCL's proposed cable system will increase capacity to and from India

Details of submarine cable capacity of Indian companies and major cable systems into and from India

Company	Cable	Capacity (Gbps)	Coverage	Landing station	Length (Route km)
<b>Videsh Sanchar Nigam Ltd. (VSNL)</b>					
	SEA-ME-WE2	1,100	13 countries (FRA - SGP)	Mumbai	18,000
	SEA-ME-WE3	505	33 countries (GER-JPN-AUS)	Mumbai, Kochi	39,000
	SAFE/WASC/SAT-3	250	Europe-Africa-SE Asia	Kochi	28,800
	Fujairah Analog Cable		India-Middle East	Mumbai	
	SEA-ME-WE4	1,280	14 countries		20,000
	Tata Indicom Cable (TIC)	5,120	India-Singapore	Chennai	3,175
	TGN	14,720			60,000
	Trans-Pacific	7,680			
	Trans-Atlantic	2,560			
	Western Europe	3,840			
	Northern Europe Ring	640			
<b>Reliance Communications</b>					
	FLAG	5,360	28 countries (US East Coast-Europe-ME-India-SE Asia-Japan)		52,000
	Atlantic 1	2,400			27,000
	Europe-Asia	80			12,800
	North Asia Loop	2,880			11,000
	FLAG NGN System 1		Asia (India-SE Asia)		
	FLAG NGN System 2		Africa		
	FLAG NGN System 3		Mediterranean		
	FLAG NGN System 4		Trans-Pacific (US West coast-Japan-China-HK)		
	FALCON	2,560	12 countries (N Africa-Europe-Gulf-Asia)		11,589
<b>Bharti Airtel</b>					
	i2i	8,400	India - Singapore	Chennai	3,200

Source: Companies, compiled by Kotak Institutional Equities estimates.

## Broadband segment: Exploitation of broad pipes is key

**RCL's broadband business may lag its wireless business unless it invests in expensive last-mile (access) connection. In the retail segment, we believe RCL will have to develop alternative revenue streams to recoup investment in costly fiber given incumbent fixed-line operators have cut the price of broadband connectivity to uneconomical levels for new entrants.**

### Plenty of scope to grow but economics and competition are issues

**RCL's revenues and growth in revenues for the broadband and fixed-telephony segment would depend on its willingness to spend large amounts of capex in access infrastructure and expand to more cities.** We believe RCL has significant opportunity to grow its broadband business (both enterprise and retail) but it will have to invest in the business with likely low returns in the initial period.

**RCL's historical performance has been significantly below its potential.** We attribute this to its late entry and reluctance to spend large required capex in the broadband and telephony (BB&T). RCL has been relatively more successful in the non-access data segment with a strong presence in the IDC market, where it is the market leader with a 50% market share.

Enterprise BB—Reliance may be lagging due to its late entry

**We are surprised by the sedate pace of subscriber addition in this segment with RCL far lagging Bharti.** In particular, we highlight that RCL had 0.4 mn fixed-line subs compared to Bharti's 1.63 mn and reach of 30 towns compared to Bharti's 94 at end-2QFY07.

We are somewhat puzzled by RCL's low subscriber figures despite its decent reach in terms of connected buildings. At end-September 2006, RCL had 425,000 subs versus connected buildings of 270,000 or about 1.5 subs/connected building; this looks very low to us. We are not sure why RCL is not able to leverage its reach to scale up its subscriber base. Perhaps RCL is not able to dislodge incumbents or Bharti/TTSL, which may be providing broadband and fixed-line telephony services to those buildings or perhaps it is coy about investing in this business without visibility on better economics.

Economics may be a big bottleneck

**Exhibit 21 shows the low profitability and returns of Bharti and RCL in the BB&T segment** and underscores that high requisite investment will likely result in low returns and profitability during the investment phase; the returns are significantly lower than in wireless. We note that RCL's profitability and returns would be similar or lower than those of Bharti excluding the contribution of other data services (RCL clubs all enterprise revenues in this segment while Bharti shows other data services separately).



**Exhibit 21: Growth in BB&T segment may be difficult without large capex**

Profitability and CROCI of BB&amp;T segment of Bharti and RCL based on 1HFY07 data (Rs mn)

	Bharti	Reliance
Revenues	10,426	4,981
EBITDA	2,262	2,097
<b>EBITDA margin (%)</b>	<b>21.7</b>	<b>42.1</b>
EBIT	579	1,369
EBIT*(1-t)	515	1,333
Add: Depreciation	1,683	728
Cash return	2,198	2,061
Annualized cash return	4,395	4,121
<b>Gross cash invested (GCI)</b>	<b>41,607</b>	<b>26,290</b>
<b>CROCI (%)</b>	<b>10.6</b>	<b>15.7</b>
Number of BB&T subscribers, September 2006	1,631	392
Number of cities covered, September 2006	94	30

Note:

- (a) Bharti's figures do not include contribution from its enterprise corporate segment.  
(b) Reliance's figures include contribution from corporate enterprises segment.

Source: Kotak Institutional Equities estimates.

**Retail BB—Tough to match pricing of incumbent operators**

**We do not model any meaningful revenues for RCL from this segment.** We believe RCL will have to change its approach (compromise on profitability) and offer a unique proposition (combination of voice, data and video at competitive rates) to consumers if it has to build a significant retail presence.

**In our view, RCL may not be competitive with incumbent fixed-line operators in normal access broadband service.** We believe the incumbents will be much more competitive than new entrants given their depreciated copper network and capability to provide DSL broadband service at very competitive rates. Exhibit 22 shows the competitiveness of the retail broadband plans of BSNL and Mahanagar Telephone Nigam Ltd. (MTNL) versus those of RCL and other new players.

**Exhibit 22: BSNL offers the lowest broadband tariffs in the country**

Comparison of RCL's broadband tariffs with those of rival operators (Rs)

	Bharti	BSNL	MTNL	RCL	RCL
<b>Monthly rental</b>	<b>500</b>	<b>250</b>	<b>250</b>	<b>300</b>	<b>600</b>
Bandwidth (kbps)	256	256	256	600	1,000
Free upload/download (MB)	1,024	1,024	1,024	350	1,024
Additional usage charge/MB	1.2	0.9	1.0	1.3	1.3
<b>Effective charge (for 2,048 MB usage)</b>	<b>1,729</b>	<b>1,172</b>	<b>1,274</b>	<b>2,423</b>	<b>1,880</b>
Service tax	212	143	156	297	230
<b>Total charge</b>	<b>1,940</b>	<b>1,315</b>	<b>1,430</b>	<b>2,719</b>	<b>2,110</b>

Notes:

- (a) Effective charge for 2 GB per month usage.

Source: Companies, compiled by Kotak Institutional Equities.

**We are also not convinced about the potential of IPTV currently, RCL's other retail initiative; cable TV is very competitively priced in India.** We do not have issues about RCL's execution or technology, which is fairly well established now. However, we do not think the economics will work at typical ARPUs (voice and video) in India. Most households in India would have a typical monthly spend of about Rs400-500 (US\$9-11/month) on voice (fixed-line phone) and cable TV. Also, we believe most may not need a broadband service at this point given very low PC penetration.

## Key issues: Quality of wireless subs, disclosures

We believe additional disclosures on certain key parameters will enhance RCL's valuations. These include (1) breakdown of key parameters of wireless and fixed-wireless segments; (2) breakdown of license and interconnection costs; and (3) additional disclosures on the LD segment.

### Quality of wireless revenues and subs

We estimate RCL derives a meaningful portion (about 20%) of its wireless revenues from the PCO phones/subscribers. This raises two issues about RCL's wireless segment.

1. **RCL's wireless ARPU may be bolstered by significantly higher ARPUs of PCOs versus normal wireless subscribers;** this raises issues about the quality of subscribers of RCL. Exhibit 23 gives our estimate of ARPUs of and revenue contribution from various sub-segments (pure wireless, fixed-wireless PCO and fixed-wireless non-PC) of RCL's wireless segment.

#### Exhibit 23: We believe high ARPUs of PCOs mask low ARPUs of normal wireless subscribers of RCL

Rough estimation of ARPUs of various wireless sub-segments of RCL (Rs/month)

	Mar-06	Jun-06	Sep-06
No. of wireless subscribers (mn)	20.3	22.5	26.0
<b>No. of mobile subscribers (mn)</b>	<b>17.3</b>	<b>19.2</b>	<b>22.2</b>
No. of fixed-wireless subscribers (mn)	3.0	3.4	3.8
No. of PCOs (mn)	0.9	1.1	1.3
No. of non-PCO fixed-wireless subscribers (mn)	2.0	2.2	2.5
<b>Reported ARPU of wireless segment</b>	<b>379</b>	<b>379</b>	<b>354</b>
<b>Estimated PCO ARPU (@ 5X wireless only ARPU)</b>		<b>1,466</b>	<b>1,369</b>
Estimated non-PCO FW ARPU (@ 2X wireless only ARPU)		586	548
<b>Estimated wireless only ARPU</b>		<b>293</b>	<b>274</b>
<b>Share of revenues of PCOs (%)</b>		<b>19</b>	<b>19</b>
Share of revenues of non-PCO fixed-wireless subs (%)		15	15
Share of revenues of wireless subs (%)		66	66

Note:

- (a) The ratio of ARPUs of various sub-segments is an estimate; the actual ratios may be different.
- (b) Sep-06 data for fixed-wireless subs and PCOs is an estimate.

Source: Kotak Institutional Equities estimates.

2. **RCL's wireless revenues may not grow in line with industry revenues** as we expect PCO revenues to grow gradually or even decline longer-term as wireless penetration increases. We have seen this in case of MTNL, whose PCO revenues have declined sharply over the past few quarters as wireless penetration has increased in Delhi and Mumbai (see Exhibit 24). It is unlikely RCL will capture all subscribers moving to a wireless service from predominantly PCO usage.

**Exhibit 24: PCO revenues of MTNL have shrunk with increased penetration of wireless in Delhi and Mumbai**

PCO revenues of MTNL and wireless penetration in Delhi and Mumbai

	Jun-05	Sep-05	Dec-05	Mar-06	Jun-06	Sep-06
<b>MTNL PCO phone revenues (Rs mn)</b>	<b>2,354</b>	<b>2,251</b>	<b>2,280</b>	<b>1,992</b>	<b>1,794</b>	<b>1,608</b>
# of wireless subs in Delhi (mn)	5.9	6.5	7.1	8.1	9.1	10.0
Wireless penetration in Delhi (%)	29	32	35	39	44	48
# of wireless subs in Mumbai (mn)	5.4	5.8	6.6	7.5	8.3	8.6
Wireless penetration in Mumbai (%)	24.1	26.1	29.6	33.5	36.7	38.1
<b>Wireless penetration in Delhi and Mumbai (%)</b>	<b>26.4</b>	<b>28.8</b>	<b>32.0</b>	<b>36.3</b>	<b>40.0</b>	<b>43.0</b>

Source: MTNL, COAI, AUSPI, compiled by Kotak Institutional Equities.

**More disclosures in financial statements would help**

We note our analysis is constrained by limited disclosures on certain key operating and financial data. These include.

- 1. No breakdown of wireless and fixed wireless subscribers.** RCL does not provide the breakdown of its wireless subs between wireless and fixed wireless and provides composite operating parameters (ARPU, MOU, RPM) and financials (see Exhibit 25). This makes it difficult to appreciate the quality of its subscriber base and movement in key parameters versus that of other leading operators such as Bharti. As discussed above, we believe RCL's operating parameters in the key wireless segment are supported by the better parameters of its fixed-wireless subscribers.

**Exhibit 25: RCL is lagging Bharti in wireless (mobile) net adds but is significantly ahead in the PCO segment**

Comparison of Reliance and Bharti on key subscriber parameters (mn)

	Mar-05	Jun-05	Sep-05	Dec-05	Mar-06	Jun-06	Sep-06
<b>Reliance</b>							
No. of wireless subscribers	11.8	13.4	15.1	17.3	20.3	22.5	26.0
<b>No. of mobile subscribers</b>	<b>10.5</b>	<b>11.7</b>	<b>13.0</b>	<b>14.7</b>	<b>17.3</b>	<b>19.2</b>	<b>22.2</b>
No. of fixed-wireless subscribers	1.3	1.7	2.1	2.6	3.0	3.4	3.8
No. of PCOs	0.3	0.4	0.5	0.7	0.9	1.1	
No. of fixed-line subscribers	0.1	0.1	0.2	0.2	0.2	0.3	0.4
<b>Increase in wireless (mobile only) subs</b>		<b>1.2</b>	<b>1.3</b>	<b>1.7</b>	<b>2.6</b>	<b>1.9</b>	<b>3.1</b>
<b>Bharti</b>							
<b>No. of wireless subscribers</b>	<b>11.0</b>	<b>12.3</b>	<b>14.1</b>	<b>16.3</b>	<b>19.6</b>	<b>23.1</b>	<b>27.1</b>
No. of PCOs	0.1	0.1	0.5	0.2	0.2	0.2	
No. of fixed-line subscribers	0.8	0.9	1.0	1.2	1.3	1.5	1.6
<b>Increase in wireless (mobile only) subs</b>		<b>1.3</b>	<b>1.8</b>	<b>2.3</b>	<b>3.3</b>	<b>3.5</b>	<b>4.0</b>

Source: TRAI quarterly performance reports, compiled by Kotak Institutional Equities.

- 2. Breakup of license and interconnection costs.** We consider this important since the management attributes the recent improvement in quarterly EBITDA to a higher proportion of on-net calls and hence, lower increase in interconnection costs relative to revenues. We have tried to segregate the license and interconnection costs in Exhibit 26. It appears that interconnection costs have declined sharply qoq in 1QFY07 and moderately in 2QFY07 despite an increase in gross revenues. We attribute this to lower ADC on LD calls apart from higher on-net calls.

**Exhibit 26: Interconnection charges have declined over the past few quarters**

Estimation of breakup of license and interconnection charges (Rs mn)

	3QFY06	4QFY06	1QFY07	2QFY07
Gross revenues	19,807	21,200	24,320	25,744
Net revenues	11,521	12,645	16,544	17,998
<b>License and interconnection charges</b>	<b>8,286</b>	<b>8,555</b>	<b>7,776</b>	<b>7,746</b>
<b>License and spectrum fees (% of AGR)</b>	<b>10.0</b>	<b>10.0</b>	<b>10.0</b>	<b>10.0</b>
<b>Interconnection charges</b>	<b>7,006</b>	<b>7,150</b>	<b>5,938</b>	<b>5,746</b>
<b>License and spectrum fees</b>	<b>1,280</b>	<b>1,405</b>	<b>1,838</b>	<b>2,000</b>
EBITDA	6,364	7,571	8,766	9,294
EBIT		3,998	5,144	5,131
ARPU (Rs)	412	379	379	354
No. of minutes (bn)	26.2	29.7	31.4	33.5
MOU (min)	547	532	491	461
RPM (Rs/min)	0.76	0.71	0.77	0.77
Net RPM (Rs/min)	0.44	0.43	0.53	0.54
Wireless subs (mn)	17	20.21	22.52	25.98
Capex			8,529	14,990
Cumulative capex			155,117	170,100

Note:

(a) 10% of AGR for license and spectrum fees is an assumption.

(b) Changing the 10% figure changes the relative amounts, not the trend.

*Source: Kotak Institutional Equities estimates.*

**3. Limited availability of data on the long distance segment.** A breakdown of revenues between voice and data—yet unavailable—would help understand sustainability and growth in the business. It would also explain the segment's lower profitability versus Bharti's and whether there is scope for increase in margins, profitability and profits. We note that Bharti also does not provide a breakdown of revenues between voice and data, which makes it difficult to understand the discrepancy in the performance of the two companies' LD segments.

We think RCL's weaker financial performance could be due to two reasons: (1) RCL may have high volumes of low profitability minutes (FLAG volumes), which may result in lower EBITDA for the ILD segment; RCL's ILD volumes are significantly higher than that of Bharti; (2) RCL may have lower data revenues versus Bharti—we note profitability and margin of data is much higher than those of voice.

We highlight that RCL had EBITDA of Rs3.2 bn on revenues of Rs13.2 bn in 2QFY07 (EBITDA margin of 24.3%) compared to Bharti's Rs3.4 bn on revenues of Rs8.4 bn (EBITDA margin of 40%). This is despite much higher ILD volumes and moderately higher DLD volumes for RCL versus Bharti. Exhibit 27 compares key financial and operating parameters of RCL and Bharti.

**Exhibit 27: RCL has similar EBITDA in LD business to Bharti despite higher minutes**  
Comparison of key financial and operating parameters of RCL and Bharti (Rs mn)

	2QFY07			1QFY07		
	RCL	Bharti	Difference	RCL	Bharti	Difference
<b>Revenues</b>	<b>13,158</b>	<b>8,362</b>	<b>4,796</b>	<b>12,340</b>	<b>7,064</b>	<b>5,276</b>
Net revenues	7,283			7,174		
<b>EBITDA</b>	<b>3,199</b>	<b>3,367</b>	<b>(168)</b>	<b>2,842</b>	<b>2,750</b>	<b>92</b>
Depreciation	1,414	503	911	1,288	472	816
EBIT	1,785	2,864	(1,079)	1,554	2,278	(724)
ILD minutes (mn)	1,287	882	405	1,214	753	461
DLD minutes (mn)	3,722	3,628	94	3,085	2,882	203
<b>EBITDA margin (%)</b>	<b>24.3</b>	<b>40.3</b>	<b>(16)</b>	<b>23.0</b>	<b>38.9</b>	<b>(16)</b>
<b>Investment at end of period</b>	<b>83,820</b>	<b>32,563</b>	<b>51,257</b>	<b>80,155</b>	<b>29,033</b>	<b>51,122</b>

Source: Companies' quarterly financial reports.

### Balance sheet, accounting policies

We discuss some balance sheet issues and highlight key accounting policies of RCL, which are less conservative versus industry standards.

#### Note on balance sheet

We highlight significant changes in certain key items and unusually high figures (relative to industry) of RCL's balance sheets over the last three reported quarters; see Exhibit 28 for details. We assume that the balance sheets are comparable; RCL's September 2006 quarter statement is post the company restructuring and the previous quarters' annual reports are on a pro forma basis reflecting the restructuring.

**Exhibit 28: Key changes in RCL's balance sheet over the past three quarters**

RCL's balance sheet for the most recent quarters (Rs mn)

	Mar-06	Jun-06	Sep-06	Comments
<b>Equity</b>				
Share capital	10,223	10,223	10,223	
Reserves and surplus	107,212	112,032	170,063	Reported net profit in Sep-06 quarter was Rs7 bn
<b>Equity</b>	<b>117,435</b>	<b>122,255</b>	<b>180,286</b>	
Minority interest	96	99	99	
Debt	103,332	119,075	123,660	
Current liabilities	80,170	102,320	117,885	Includes suppliers credit (Rs19 bn) and advance from customers (Rs34 bn); creditors has increased by Rs51bn over past two quarters
Provisions	18,705	19,776	46,236	Includes Rs18 bn of disputed claims with BSNL/MTNL; will probably need to paid. No explanation available for the sharp increase in 2QFY07
<b>Total capital</b>	<b>319,738</b>	<b>363,525</b>	<b>468,166</b>	
<b>Assets</b>				
Cash	37,995	94,665	103,082	Large cash balance needs to be adjusted for high current liabilities & provisions
Inventories	4,076	3,982	3,970	
Debtors	16,808	17,271	19,509	
Other current assets	765	1,547	1,434	
Loans and advances	23,668	21,459	24,551	
Gross block	228,295	234,730	327,706	Capex in Sep-06 quarter was Rs16 bn; this may be due to revaluation
Less: Depreciation	47,573	53,299	60,569	
Net block	180,722	181,431	267,137	
Capital work in progress	31,305	40,733	46,121	C-WIP is very high by industry standards
Goodwill	2,237	2,308	2,237	
Investments	22,163	129	125	
<b>Total assets</b>	<b>319,739</b>	<b>363,525</b>	<b>468,166</b>	

Note:

(a) Mar-06 and Jun-06 quarters balance sheets are on pro forma basis; we assume these are comparable with Sep-06 quarter balance sheet of RCL.

Source: Company's quarterly financial reports.

1. **Steep increase in gross block and equity in 2QFY07.** RCL's gross block jumped by Rs93 bn in 2QFY07 (reported capex was Rs16 bn in the quarter while capital WIP increased by Rs5.4 bn) with a corresponding increase in equity of Rs58 bn (net income was Rs7 bn in the quarter) and current liabilities. The management has not provided any explanation for the same in the quarterly report. End-September 2006 figures are as per consolidated balance sheet after the reorganization of the company while end-June 2006 figures are as per pro forma balance sheet of the same entities. We assume these are comparable.
2. **Large capital WIP.** We note that RCL had a large C-WIP of Rs46 bn at end-2QFY07, up Rs5.4 bn from end-1QFY07. We find the large C-WIP hard to explain; telecom companies do not have such high C-WIP typically since the time required for commissioning new assets (towers) is relatively small. Also, RCL had commissioned its FALCON submarine cable system in September, which should have resulted in a steep decline in C-WIP.
3. **Sharp increase in provisions in 1HFY07.** RCL's provisions increased to Rs46 bn at end-2QFY07 compared to Rs19.3 bn at end-FY2006. We are not sure why this has increased so dramatically in 1HFY07.
4. **High current liabilities.** We find RCL's current liabilities (excluding provisions) extraordinarily high at Rs118 bn at end-2QFY0 and also find the steep increase of Rs38 bn in the six months of 1HFY07 puzzling. Over this period, advances from customers and deferred revenues have declined by Rs13 bn, which implies payables (trade and capex) has increased by Rs51 bn. Typically, creditors would include payment payable to the government (license fees), other operators (interconnection) and equipment suppliers.
5. **Large advances from customers.** RCL's advances from customers and deferred revenues stood at Rs34 bn at end-2QFY07 versus Bharti's Rs15 bn. We can only attribute this to FLAG, where RCL may have received advances from customers for the use of bandwidth for a certain period (IRU). Given Bharti's higher number of pre-paid wireless subscribers versus RCL (23 mn versus 21 mn at end-September 2006), we would expect it to have higher advances from customers. We also expect Bharti's pre-paid ARPU to be higher than that of RCL. We assume the bulk of RCL's fixed-wireless (including PCOs) subscribers with higher ARPUs versus mobile wireless subscribers will likely be post-paid subscribers.

#### Accounting policies

1. **Depreciation.** Exhibit 29 shows that the depreciation rates used by RCL are lower versus corresponding depreciation rates used by Bharti. Accordingly, RCL's net income may be inflated relative to Bharti and thus, we do not advocate EPS and P/E comparison unless adjusted for common depreciation rates.
2. **Accounting standard.** RCL follows Indian GAAP while Bharti follows US GAAP for primary reporting. USGAAP is somewhat more stringent on foreign exchange gain/loss treatment.

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**Exhibit 29: RCL's depreciation rates are less conservative versus Bharti's**  
Depreciation rates used by Bharti and RCL (# of years)

	<b>RCL</b>	<b>Bharti</b>
Buildings	30-60	20
Plant and machinery	10-20	10-15
Furniture and fixture	15	5
Office equipment	20	5
Vehicles	10	5

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*Source: Companies.*



## Financials: Earnings set to grow strongly

We model RCL's revenues to grow to Rs318 bn in FY2010E from Rs106 bn in FY2006 and drive net income to Rs68 bn in FY2010E from Rs4.8 bn in FY2006. The improvement in net income and lower capex due to lower wireless additions will likely result in free cash flow generation from FY2010E, which in turn will result in de-leveraging of the balance sheet.

### Wireless is the big driver of overall revenues

Exhibit 30 gives the key assumptions behind our earnings model. We expect the wireless segment to power overall revenues and EBITDA (see Exhibit 31, which gives the breakdown of revenues and EBITDA by segment) unless RCL decides to expand its BB&T segment (both enterprise and retail) more aggressively. We have already discussed the major assumptions behind revenues in the individual sections.

**Exhibit 30: Key macro assumptions for Reliance Communications, March fiscal year-ends, 2006-2016E**

	2006	2007E	2008E	2009E	2010E	2011E	2012E	2013E	2014E	2015E	2016E
<b>Wireless</b>											
Market subscribers (mn)	90	164	231	297	351	389	421	450	477	503	528
Market penetration (%)	8	14	20	26	30	33	35	37	39	40	42
RCL subs including fixed wireless (mn)	20	35	48	61	70	77	83	88	93	98	103
RCL market share (%)	23	21	21	20	20	20	20	20	20	20	19
<b>Market revenues (Rs bn)</b>											
Market revenues (Rs bn)	366	534	760	976	1,189	1,346	1,468	1,583	1,693	1,802	1,908
RCL's revenues (Rs bn)	74	109	152	189	222	251	274	294	314	333	352
RCL's market share (%)	20	20	20	19	19	19	19	19	19	18	18
<b>RCL subs (mn)</b>											
RCL subs (mn)	20	35	48	61	70	77	83	88	93	98	103
RCL prepaid subs ('000)	16	29	41	52	61	68	73	77	82	86	82
RCL postpaid subs ('000)	4	5	7	8	9	9	10	10	11	11	12
RCL FWP & PCO subs ('000)	3	4	5	6	7	7	8	8	8	9	9
<b>RCL blended ARPU (Rs/month)</b>											
RCL blended ARPU (Rs/month)	385	332	306	290	283	283	284	285	287	290	292
RCL prepaid ARPU (Rs/month)	340	290	268	254	249	250	251	253	255	257	259
RCL postpaid ARPU (Rs/month)	511	502	492	489	481	477	484	489	494	499	504
<b>RCL blended MOU (mins/month)</b>											
RCL blended MOU (mins/month)	531	436	429	426	426	431	434	437	441	444	448
RCL prepaid MOU (mins/month)	492	398	396	395	396	402	405	409	412	416	420
RCL postpaid MOU (mins/month)	676	607	612	617	622	627	631	636	641	646	651
<b>RCL blended RPM (Rs) (ARPU/MOU)</b>											
RCL blended RPM (Rs) (ARPU/MOU)	0.7	0.8	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.7
RCL prepaid RPM (Rs/min) (ARPU/MOU)	0.7	0.7	0.7	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6
RCL postpaid RPM (Rs/min) (ARPU/MOU)	0.8	0.8	0.8	0.8	0.8	0.8	0.8	0.8	0.8	0.8	0.8
<b>RCL overall RPM (Rs/min)</b>	<b>1.0</b>	<b>1.0</b>	<b>0.9</b>	<b>0.9</b>	<b>0.8</b>	<b>0.8</b>	<b>0.8</b>	<b>0.8</b>	<b>0.8</b>	<b>0.8</b>	<b>0.8</b>
<b>Blended EBITDA per min (Rs)</b>											
Blended EBITDA per min (Rs)	0.31	0.38	0.35	0.32	0.32	0.32	0.32	0.32	0.32	0.32	0.32
<b>EBITDA margin (%)</b>	<b>30</b>	<b>37</b>	<b>37</b>	<b>37</b>	<b>38</b>	<b>38</b>	<b>39</b>	<b>39</b>	<b>39</b>	<b>40</b>	<b>40</b>
<b>Capex/incremental min (Rs)</b>											
Capex/incremental min (Rs)	1.1	1.1	0.9	0.8	0.8	0.7	0.7	0.6	0.6	0.6	0.6
Capex incl. maintenance capex/incremental min (Rs)	1.1	1.1	0.9	0.9	0.8	0.8	0.9	1.0	1.2	1.3	1.4
<b>Capex/incremental sub (US\$)</b>											
Capex/incremental sub (US\$)	137	65	95	93	97	101	92	87	85	84	83
Capex incl. maintenance capex/incremental sub (US\$)	137	65	97	97	105	118	126	140	164	180	197
<b>Domestic long distance</b>											
Market revenues (Rs bn)	103	108	129	156	176	193	208	222	236	250	263
Revenues to DLD operator (net of orig.)	62	70	81	92	99	107	115	124	133	142	151
RCL's revenues (Rs bn)	12	13	19	22	24	26	28	30	32	33	35
RCL's market share (%)	19	18	23	24	24	25	24	24	24	24	23
<b>International long distance</b>											
Market revenues (Rs bn)	66	56	63	73	84	95	107	116	127	138	150
RCL's IDD revenue (Rs bn)	19	16	18	20	22	24	27	30	32	35	38
RCL's market share (%)	28	29	28	27	26	25	26	25	25	25	25
Market minutes (bn mins)	11	15	19	23	28	31	36	39	42	46	50
RCL's share of mins (%)	40	36	35	33	31	30	29	29	29	29	29

Source: Kotak Institutional Equities estimates.

**Exhibit 31: Business segment revenue and profitability, March fiscal year-ends, 2004-2016E (Rs mn)**

	2006	2007E	2008E	2009E	2010E	2011E	2012E	2013E	2014E	2015E	2016E
<b>Revenues</b>											
Wireless	73,627	109,357	151,874	189,330	222,225	250,833	273,721	294,019	313,727	333,147	352,112
Global business	51,858	55,770	70,623	86,585	102,088	117,790	129,878	139,398	147,437	156,093	165,173
Broadband	5,118	11,751	19,422	27,860	36,432	44,462	51,634	57,845	63,276	68,272	73,197
Others	3,011	5,346	5,880	6,468	7,115	7,826	8,609	9,470	10,417	11,459	12,605
Less: Intersegment eliminations	(27,341)	(31,487)	(40,192)	(44,105)	(49,638)	(56,654)	(61,821)	(66,163)	(70,030)	(74,265)	(78,662)
<b>Total revenues</b>	<b>106,273</b>	<b>150,737</b>	<b>207,607</b>	<b>266,139</b>	<b>318,221</b>	<b>364,257</b>	<b>402,021</b>	<b>434,568</b>	<b>464,827</b>	<b>494,705</b>	<b>524,425</b>
<b>EBITDA</b>											
Wireless	22,300	40,070	55,945	69,772	84,205	96,045	106,310	114,851	123,218	132,751	141,651
Global business	6,414	14,155	18,720	22,917	26,794	31,793	35,359	38,014	40,148	42,356	44,642
Broadband	777	4,917	8,003	11,411	14,546	17,957	20,939	23,248	25,249	27,276	29,237
Others/adjustments	(6,150)	(1,304)	(2,155)	929	1,022	1,124	1,237	1,360	1,496	1,646	1,810
<b>Total EBITDA</b>	<b>23,341</b>	<b>57,838</b>	<b>80,512</b>	<b>105,029</b>	<b>126,567</b>	<b>146,919</b>	<b>163,844</b>	<b>177,473</b>	<b>190,111</b>	<b>204,028</b>	<b>217,341</b>
<b>Revenues, proportion of total (%)</b>											
Wireless	69	73	73	71	70	69	68	68	67	67	67
Global business	49	37	34	33	32	32	32	32	32	32	31
Broadband	5	8	9	10	11	12	13	13	14	14	14
Others	3	4	3	2	2	2	2	2	2	2	2
Less: Intersegment eliminations	(26)	(21)	(19)	(17)	(16)	(16)	(15)	(15)	(15)	(15)	(15)
<b>Total</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>
<b>EBITDA, proportion of total (%)</b>											
Wireless	96	69	69	66	67	65	65	65	65	65	65
Global business	27	24	23	22	21	22	22	21	21	21	21
Broadband	3	9	10	11	11	12	13	13	13	13	13
Others	(26)	(2)	(3)	1	1	1	1	1	1	1	1
<b>Total</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>
<b>EBITDA margin (%)</b>											
Wireless	30	37	37	37	38	38	39	39	39	40	40
Global business	12	25	27	26	26	27	27	27	27	27	27
Broadband	15	42	41	41	40	40	41	40	40	40	40
Others	(204)	(24)	(37)	14	14	14	14	14	14	14	14
<b>Total</b>	<b>22</b>	<b>38</b>	<b>39</b>	<b>39</b>	<b>40</b>	<b>40</b>	<b>41</b>	<b>41</b>	<b>41</b>	<b>41</b>	<b>41</b>

Source: Kotak Institutional Equities estimates.

## Key cost items

We focus on our key cost assumptions below.

- 1. License fees.** We model license fees for the wireless and fixed-line segments at 6, 8 and 10% of AGR for metro/A, B and C circles, respectively. For the LD segment, we keep the license fees at 6%. If the government was to reduce the license fees for the wireless and fixed-line segments to a uniform 6%, our FY2008E and FY2009E EPS estimates would increase to Rs22.4 and Rs27.9, respectively, versus our current forecasts of Rs20.8 and Rs26.1, respectively; our one-year forward DCF valuation would increase by Rs27 to Rs401. However, we would expect the impact to be temporary as competition will whittle down any excess profitability over a period of time and the benefits of lower license fees will be passed on to consumers eventually.
- 2. Interconnection costs.** We keep interconnection and ADC at current rates throughout our forecast period. As in the case of license fees, we see the impact of any reduction to interconnection/ADC rates as likely transient. However, lower termination charges may be negative for profitability and profits as we expect lower termination charges to likely lead to lower outgoing tariffs. We expect the regulator to revisit termination charge in the future going by its recommendation for lower roaming tariffs; it has argued in its consultation paper that an increase in roaming minutes has led to a decline in incremental cost of roaming. We note that the mobile termination charge has remained unchanged at Rs0.3/min since April 2003 although the number of minutes has exploded since then. For example, we note that Bharti's total number of minutes was 33.8 bn in 2QFY07 compared to 6 bn in FY2003.

3. **Interest expense.** We model interest expense to remain stable until FY2010 and then decline as RCL begins to generate free cash flow from FY2010 and pay down debt.
4. **Depreciation.** We model RCL's depreciation (including amortization) to increase to Rs47 bn in FY2010E versus Rs27 bn in FY2007E (Rs11.8 bn in 1HFY07). We assume in our model that RCL will continue with its CDMA business and will not migrate its extant CDMA subs to GSM; it would have to write off its investment in CDMA equipment in a short time-period if it were to switch out of CDMA completely. We do not think this likely; we believe RCL will continue to offer both concurrently. We have assumed that the sharp increase in gross block in 2QFY07 is due to revaluation of assets; we write this over 10 years. However, FY2007 annual report will likely provide more clarity on the classification of the revalued assets and the applicable depreciation rates.
5. **Taxation.** We have modeled an increase in RCL's current (cash) and effective tax rates as it gradually loses income tax exemption on its various circles over the next few years. We find RCL's taxation tricky to model as various circles will enjoy different levels of exemptions at various periods of time and it is difficult to model the profits by circle. Indian telecom companies enjoy tax exemption for a block of 10 years in the first 15 years of start of operations—100% tax exemption for five years followed by 30% tax exemption for an additional five years. We assume full tax exemption in the initial years and gradually reduce exemption through FY2016.

**We note that our DCF valuation is quite sensitive to taxation assumptions.**

Between FY2007 and 2016, we model an average tax rate (both current and effective) of about 13%. Thus, higher-than-expected taxation will be negative for earnings, cash flows and valuation. We highlight that our cash and effective tax rate in the terminal year of our forecast period (F2016) is 33% and 30%, respectively.

**Exhibit 32 gives our P&L model for RCL.**

**Exhibit 32: Consolidated profit and loss for Reliance Infocomm, March fiscal year-ends, 2006-2016E (Rs mn)**

	2006	2007E	2008E	2009E	2010E	2011E	2012E	2013E	2014E	2015E	2016E
<b>Revenues</b>											
Wireless	73,627	109,357	151,874	189,330	222,225	250,833	273,721	294,019	313,727	333,147	352,112
Global business	51,858	55,770	70,623	86,585	102,088	117,790	129,878	139,398	147,437	156,093	165,173
Broadband	5,118	11,751	19,422	27,860	36,432	44,462	51,634	57,845	63,276	68,272	73,197
Others	3,011	5,346	5,880	6,468	7,115	7,826	8,609	9,470	10,417	11,459	12,605
Less: Intersegment eliminations	(27,341)	(31,487)	(40,192)	(44,105)	(49,638)	(56,654)	(61,821)	(66,163)	(70,030)	(74,265)	(78,662)
<b>Consolidated revenues</b>	<b>106,273</b>	<b>150,737</b>	<b>207,607</b>	<b>266,139</b>	<b>318,221</b>	<b>364,257</b>	<b>402,021</b>	<b>434,568</b>	<b>464,827</b>	<b>494,705</b>	<b>524,425</b>
Interconnection costs	(31,340)	(26,671)	(36,519)	(46,047)	(52,942)	(59,707)	(66,033)	(70,960)	(75,813)	(80,630)	(85,525)
License fees and spectrum charges	(9,065)	(11,671)	(16,186)	(20,530)	(24,883)	(28,448)	(31,306)	(33,831)	(36,170)	(38,466)	(40,731)
Network operating costs	(15,346)	(17,773)	(23,436)	(30,232)	(37,327)	(43,032)	(47,094)	(50,937)	(54,190)	(57,168)	(60,142)
Sales and marketing expenses	(10,358)	(14,359)	(19,422)	(24,481)	(29,424)	(32,835)	(35,699)	(38,272)	(40,695)	(43,117)	(45,534)
Employee costs	(8,394)	(10,456)	(15,543)	(19,922)	(23,562)	(26,757)	(29,079)	(32,005)	(34,847)	(36,453)	(38,169)
G&A costs	(8,429)	(11,970)	(15,989)	(19,899)	(23,517)	(26,559)	(28,966)	(31,090)	(33,001)	(34,843)	(36,984)
<b>Consolidated EBITDA</b>	<b>23,341</b>	<b>57,838</b>	<b>80,512</b>	<b>105,029</b>	<b>126,567</b>	<b>146,919</b>	<b>163,844</b>	<b>177,473</b>	<b>190,111</b>	<b>204,028</b>	<b>217,341</b>
Other income incl. Interest income	2,702	5,531	6,353	5,554	5,192	4,621	5,526	9,394	14,457	19,109	23,392
Interest expense	(3,905)	(8,005)	(8,332)	(8,567)	(7,954)	(5,689)	(1,210)	(0)	(0)	(0)	(0)
Amortization of entry fee	(3,386)	(3,347)	(3,347)	(3,347)	(3,347)	(3,347)	(3,347)	(3,347)	(3,347)	(3,347)	(3,347)
Amortization of goodwill	—	—	—	—	—	—	—	—	—	—	—
Depreciation	(13,600)	(23,865)	(29,720)	(36,741)	(43,178)	(48,254)	(52,223)	(55,850)	(59,625)	(63,680)	(67,954)
<b>Pretax profits</b>	<b>5,151</b>	<b>28,152</b>	<b>45,466</b>	<b>61,928</b>	<b>77,279</b>	<b>94,249</b>	<b>112,590</b>	<b>127,670</b>	<b>141,595</b>	<b>156,110</b>	<b>169,431</b>
Extraordinary income/(charges)	(374)	(300)	—	—	—	—	—	—	—	—	—
Prior Period Adjustments	—	—	—	—	—	—	—	—	—	—	—
Current tax expense	(151)	(1,692)	(1,969)	(6,948)	(8,671)	(10,575)	(12,633)	(14,325)	(15,887)	(39,919)	(55,364)
Deferred tax (liability)/asset	(187)	—	—	(353)	(606)	(503)	(93)	494	2,273	3,386	4,485
Minority interest expense	(6)	—	—	—	—	—	—	—	—	—	—
<b>Reported net profits</b>	<b>4,433</b>	<b>26,160</b>	<b>43,497</b>	<b>54,627</b>	<b>68,002</b>	<b>83,172</b>	<b>99,864</b>	<b>113,840</b>	<b>127,981</b>	<b>119,577</b>	<b>118,552</b>
<b>Adjusted net profits</b>	<b>4,781</b>	<b>26,441</b>	<b>43,497</b>	<b>54,627</b>	<b>68,002</b>	<b>83,172</b>	<b>99,864</b>	<b>113,840</b>	<b>127,981</b>	<b>119,577</b>	<b>118,552</b>
<b>Adjusted EPS (Rs)</b>											
Year end	2.2	12.8	21.3	26.7	33.3	40.7	47.8	54.4	61.2	57.2	56.7
Primary	2.2	12.8	21.3	26.7	33.3	40.7	47.8	54.4	61.2	57.2	56.7
Fully diluted	2.2	12.5	20.8	26.1	32.5	39.8	47.8	54.4	61.2	57.2	56.7
<b>Shares outstanding (mn)</b>											
Year end	2,045	2,045	2,045	2,045	2,045	2,045	2,091	2,091	2,091	2,091	2,091
Primary	2,045	2,045	2,045	2,045	2,045	2,045	2,091	2,091	2,091	2,091	2,091
Fully diluted	2,045	2,091	2,091	2,091	2,091	2,091	2,091	2,091	2,091	2,091	2,091
<b>Growth (%)</b>											
Revenues	97	42	38	28	20	14	10	8	7	6	6
EBITDA	(57)	148	39	30	21	16	12	8	7	7	7
Net profits	—	453	65	26	24	22	20	14	12	(7)	(1)
EPS	—	477	66	26	24	22	20	14	12	(7)	(1)
<b>Margin (%)</b>											
EBITDA	22.0	38.4	38.8	39.5	39.8	40.3	40.8	40.8	40.9	41.2	41.4
Net profits	4.5	17.5	21.0	20.5	21.4	22.8	24.8	26.2	27.5	24.2	22.6
Current tax rate (%)	3.2	6.1	4.3	11.2	11.2	11.2	11.2	11.2	11.2	25.6	32.7
Effective tax rate (%)	7.1	6.1	4.3	11.8	12.0	11.8	11.3	10.8	9.6	23.4	30.0
DPS (for a Rs5 share)	—	—	—	—	5.0	8.1	11.9	16.3	21.4	22.9	22.7
Dividend pay-out (%)	—	—	—	—	15.0	20.0	25.0	30.0	35.0	40.0	40.0

Source: Kotak Institutional Equities estimates.

### Cash flow—free cash flow from FY2010E

We model RCL to generate meaningful free cash flow from FY2010 (see Exhibit 33, our cash flow model for RCL) as EBITDA increases rapidly over the next few years and wireless additions likely slow down. We expect wireless capex to dominate RCL's overall capex over the next few years. RCL's capex and composition of capex in the outer years will depend on its keenness to pursue fixed-line and retail broadband customers.

**Exhibit 33: Consolidated cash flow statement for Reliance Communications, March fiscal year-ends, 2006-2016E**  
**(Rs mn)**

	2006	2007E	2008E	2009E	2010E	2011E	2012E	2013E	2014E	2015E	2016E
<b>Operating</b>											
Net profits before tax	4,770	27,852	45,466	61,928	77,279	94,249	112,590	127,670	141,595	156,110	169,431
Depreciation	13,600	23,865	29,720	36,741	43,178	48,254	52,223	55,850	59,625	63,680	67,954
Amortization	3,386	3,347	3,347	3,347	3,347	3,347	3,347	3,347	3,347	3,347	3,347
Taxes paid	(337)	(1,692)	(1,969)	(6,948)	(8,671)	(10,575)	(12,633)	(14,325)	(15,887)	(39,919)	(55,364)
Other income	(53)	(5,531)	(5,531)	(6,353)	(5,554)	(5,192)	(4,621)	(5,526)	(9,394)	(14,457)	(19,109)
Interest expenses	2,595	8,005	8,332	8,567	7,954	5,689	1,210	—	—	—	—
Interest paid	(2,595)	(6,483)	(6,645)	(6,697)	(5,881)	(3,390)	(1,210)	—	—	—	—
Extraordinary items	371	—	—	—	—	—	—	—	—	—	—
Misc. expenditure	746	—	—	—	—	—	—	—	—	—	—
Working capital changes (a)	17,304	33,148	(1,303)	(8,756)	(8,411)	(6,459)	(2,244)	2,805	1,833	1,351	1,322
<b>Total operating</b>	<b>39,788</b>	<b>82,510</b>	<b>71,417</b>	<b>81,829</b>	<b>103,242</b>	<b>125,925</b>	<b>148,663</b>	<b>169,822</b>	<b>181,119</b>	<b>170,113</b>	<b>167,582</b>
<b>Operating, excl. working capital (b)</b>	<b>22,113</b>	<b>49,362</b>	<b>72,720</b>	<b>90,585</b>	<b>111,653</b>	<b>132,383</b>	<b>150,907</b>	<b>167,016</b>	<b>179,286</b>	<b>168,762</b>	<b>166,260</b>
<b>Investing</b>											
Capital expenditure (c)	(39,238)	(63,869)	(97,902)	(96,101)	(81,746)	(59,817)	(51,690)	(51,357)	(55,748)	(58,645)	(61,233)
Entry fees (d)	—	—	—	—	—	—	—	—	—	—	—
(Purchase)/Sale of assets/businesses (e)	(3)	—	—	—	—	—	—	—	—	—	—
(Purchase)/Sale of investments	3,066	22,042	—	—	—	—	—	—	—	—	—
Interest/dividend received	53	5,531	5,531	6,353	5,554	5,192	4,621	5,526	9,394	14,457	19,109
<b>Total investing</b>	<b>(36,122)</b>	<b>(36,296)</b>	<b>(92,371)</b>	<b>(89,748)</b>	<b>(76,191)</b>	<b>(54,626)</b>	<b>(47,069)</b>	<b>(45,831)</b>	<b>(46,354)</b>	<b>(44,189)</b>	<b>(42,125)</b>
<b>Financing</b>											
Proceeds from issue of share capital	—	—	—	—	—	—	22,222	—	—	—	—
Proceeds from borrowings	(12,960)	23,210	1,096	1,148	(20,733)	(66,047)	(51,457)	—	—	—	—
Dividends paid (f)	—	—	—	—	(11,631)	(18,967)	(28,468)	(38,942)	(51,076)	(54,539)	(54,072)
<b>Total financing</b>	<b>(12,960)</b>	<b>23,210</b>	<b>1,096</b>	<b>1,148</b>	<b>(32,364)</b>	<b>(85,015)</b>	<b>(57,702)</b>	<b>(38,942)</b>	<b>(51,076)</b>	<b>(54,539)</b>	<b>(54,072)</b>
Net increase in cash and cash equivalents	(9,251)	69,425	(19,857)	(6,771)	(5,313)	(13,715)	43,892	85,050	83,690	71,385	71,386
Beginning cash	69,409	37,995	107,420	87,562	80,791	75,478	61,763	105,654	190,704	274,394	345,779
<b>Ending cash</b>	<b>60,158</b>	<b>107,420</b>	<b>87,562</b>	<b>80,791</b>	<b>75,478</b>	<b>61,763</b>	<b>105,654</b>	<b>190,704</b>	<b>274,394</b>	<b>345,779</b>	<b>417,165</b>
Gross cash flow (b)	22,113	49,362	72,720	90,585	111,653	132,383	150,907	167,016	179,286	168,762	166,260
<b>Free cash flow (b) + (a) + (c) + (d) + (e)</b>	<b>176</b>	<b>18,641</b>	<b>(26,485)</b>	<b>(14,272)</b>	<b>21,496</b>	<b>66,108</b>	<b>96,973</b>	<b>118,465</b>	<b>125,371</b>	<b>111,467</b>	<b>106,349</b>
Excess cash flow (b) + (a) + (c) + (d) + (e) + (f)	176	18,641	(26,485)	(14,272)	9,866	47,140	68,506	79,524	74,295	56,928	52,277

Source: Kotak Institutional Equities estimates.

### Balance sheet—decline in debt from FY2009

**Exhibit 34 is our balance sheet model for RCL.** We expect debt to decline from FY2009E as RCL pays down debt led by free cash flow generation. Due to an increase in earnings between FY2006 and FY2009, we expect RCL's ROAE to improve to 23.1% in FY2010E from 21.2% in FY2007E and ROACE to increase to 17.6% in FY2010E from 13.4% in FY2007E.

**Exhibit 34: Consolidated balance sheet for Reliance Communication, March fiscal year-ends, 2006-2016E (Rs mn)**

	2006	2007E	2008E	2009E	2010E	2011E	2012E	2013E	2014E	2015E	2016E
<b>Equity</b>											
Share capital	10,223	10,223	10,223	10,223	10,223	10,223	10,454	10,454	10,454	10,454	10,454
Warrants	—	—	—	—	—	—	—	—	—	—	—
Reserves/surplus	107,196	215,630	259,127	313,754	370,125	434,329	527,717	602,615	679,520	744,558	809,038
<b>Total equity</b>	<b>117,420</b>	<b>225,853</b>	<b>269,350</b>	<b>323,977</b>	<b>380,348</b>	<b>444,552</b>	<b>538,171</b>	<b>613,069</b>	<b>689,974</b>	<b>755,012</b>	<b>819,493</b>
Minority shareholding	96	96	96	96	96	96	96	96	96	96	96
Deferred tax liability	16	16	16	369	975	1,478	1,571	1,077	—	—	—
<b>Liabilities</b>											
Long term borrowings	94,782	119,513	122,297	125,315	115,206	51,457	—	—	—	—	—
Short term borrowings	8,550	8,550	8,550	8,550	—	—	—	—	—	—	—
<b>Total borrowings</b>	<b>103,332</b>	<b>128,063</b>	<b>130,847</b>	<b>133,865</b>	<b>115,206</b>	<b>51,457</b>	—	—	—	—	—
Current liabilities	98,874	135,026	125,756	122,102	113,771	110,515	111,095	113,707	117,694	121,165	124,546
<b>Total capital</b>	<b>319,737</b>	<b>489,055</b>	<b>526,064</b>	<b>580,408</b>	<b>610,395</b>	<b>608,098</b>	<b>650,933</b>	<b>727,949</b>	<b>807,764</b>	<b>876,273</b>	<b>944,135</b>
<b>Assets</b>											
Cash	37,995	107,420	87,562	80,791	75,478	61,763	105,654	190,704	274,394	345,779	417,165
Current assets	45,316	48,320	40,353	45,455	45,534	48,736	51,561	51,367	53,521	55,641	57,700
Gross block	228,295	374,438	472,339	568,440	650,186	710,003	761,693	813,049	868,797	927,443	988,676
Less: accumulated depreciation	47,573	74,785	107,852	147,940	194,465	246,067	301,637	360,834	423,807	490,834	562,136
<b>Net fixed assets</b>	<b>180,722</b>	<b>299,653</b>	<b>364,488</b>	<b>420,500</b>	<b>455,721</b>	<b>463,936</b>	<b>460,056</b>	<b>452,215</b>	<b>444,991</b>	<b>436,609</b>	<b>426,541</b>
Capital work-in-progress	31,305	31,305	31,305	31,305	31,305	31,305	31,305	31,305	31,305	31,305	31,305
Total fixed assets	212,027	330,957	395,792	451,805	487,025	495,241	491,360	483,520	476,295	467,913	457,845
Goodwill	2,237	2,237	2,237	2,237	2,237	2,237	2,237	2,237	2,237	2,237	2,237
Investments	22,163	121	121	121	121	121	121	121	121	121	121
Deferred expenditure	—	—	—	—	—	—	—	—	—	—	—
Deferred tax asset	—	—	—	—	—	—	—	—	1,196	4,582	9,067
<b>Total assets</b>	<b>319,737</b>	<b>489,055</b>	<b>526,065</b>	<b>580,408</b>	<b>610,395</b>	<b>608,098</b>	<b>650,933</b>	<b>727,949</b>	<b>807,764</b>	<b>876,273</b>	<b>944,135</b>
<b>Leverage ratios (%)</b>											
Debt/equity	88.0	56.7	48.6	41.3	30.3	11.6	0.0	0.0	0.0	0.0	0.0
Debt/capitalization	46.8	36.2	32.7	29.2	23.2	10.4	0.0	0.0	0.0	0.0	0.0
Net debt/equity	55.6	9.1	16.1	16.4	10.4	(2.3)	(19.6)	(31.1)	(39.8)	(45.8)	(50.9)
Net debt/capitalization	35.8	8.4	13.8	14.1	9.5	(2.4)	(24.4)	(45.2)	(66.0)	(84.5)	(103.7)
RoAE	8.1	15.4	17.6	18.4	19.3	20.2	20.3	19.8	19.6	16.6	15.1
<b>RoAE (excl cash and interest income)</b>	<b>4.8</b>	<b>21.2</b>	<b>24.9</b>	<b>23.4</b>	<b>23.1</b>	<b>22.9</b>	<b>23.2</b>	<b>24.6</b>	<b>27.4</b>	<b>25.4</b>	<b>25.2</b>
ROACE	7.6	11.8	13.6	14.5	15.7	17.7	19.5	19.7	19.6	16.5	15.1
<b>Post-tax ROACE (excl. cash/int. inc.)</b>	<b>6.5</b>	<b>13.4</b>	<b>16.2</b>	<b>16.6</b>	<b>17.6</b>	<b>19.6</b>	<b>22.1</b>	<b>24.6</b>	<b>27.4</b>	<b>25.4</b>	<b>25.2</b>

Source: Kotak Institutional Equities estimates.

As discussed in the previous section, RCL's balance sheet has several unresolved issues, the resolution of which can alter it significantly versus its current form. We highlight certain key assumptions made by us while modeling RCL's balance sheet.

- 1. Steep increase in gross block in 2QFY07.** We assume this is due to revaluation of assets, which results in higher depreciation in the future.
- 2. Provision for disputed claims of Rs18.2 bn; assumed RCL pays cash.** We assume RCL will pay a disputed amount of Rs17.5 bn with BSNL and MTNL, which would reduce provision and cash from the balance sheet. Out of the Rs18.2 bn, Rs17.5 bn pertains to disputed claims for illegal routing of international calls. If RCL has to write off the new provision (increase in 2QFY07) also eventually or settle it against cash, it would reduce certain assets and/or cash significantly.
- 3. Lower current liabilities due to payment of suppliers' credit.** We model current liabilities to decline in the future and thus, result in lower cash. We expect suppliers' credit to decline over the next few years as yearly capex declines (due to lower wireless net additions) and equipment suppliers tighten their current rather lenient payment terms. RCL had Rs19 bn of buyers' credit and Rs44 bn of sundry creditors at end-1HFY07; we assume some portion of the sundry creditors also pertains to credit by equipment suppliers.

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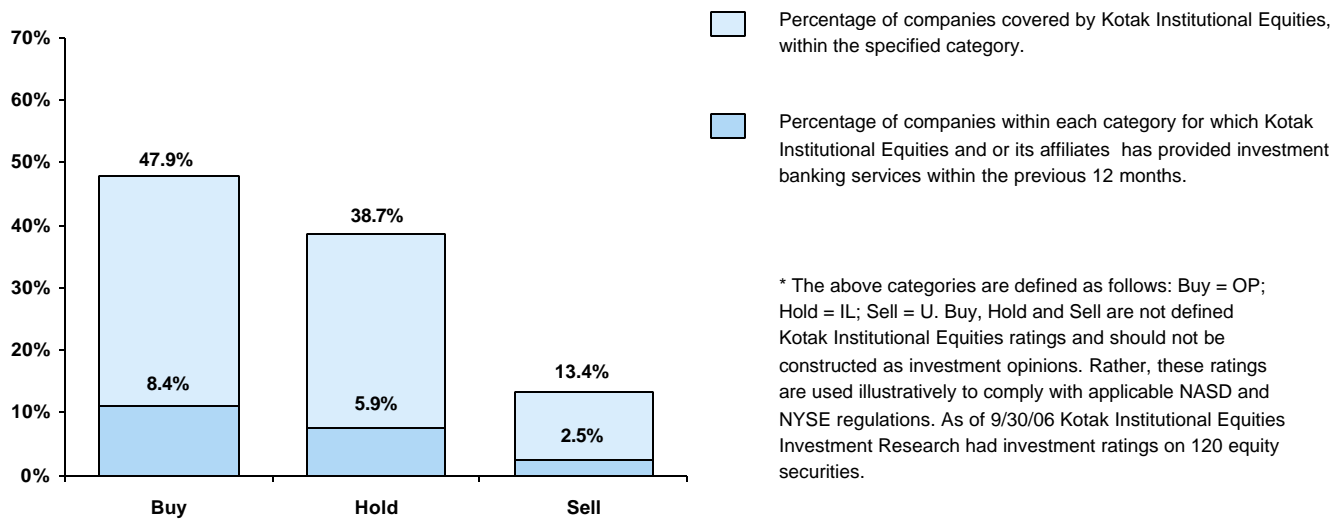




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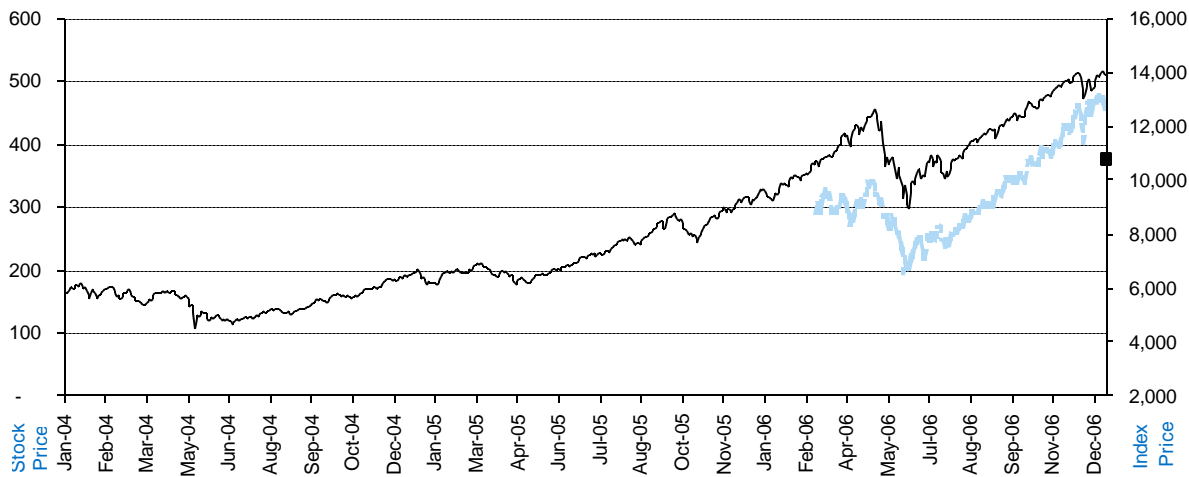


Source: Kotak Institutional Equities.

As of September 30, 2006

**Reliance Communications (RLCM.BO)**

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