kotak Institutional Equities

Bharti Airtel (BHARTI)

Telecom

ADD

SEPTEMBER 13, 2011

UPDATE

Coverage view: Cautious

Price (Rs): 382

Target price (Rs): 460

BSE-30: 16,467

Quantifying Bharti's currency exposure. Bharti's FC debt (substantial at ~US$11 bn at end-June 2011) and other FC liabilities (equipment payables, mostly in US$ and Euro) exposes it to the risk of US$/Euro appreciation versus local functional currencies (INR and various African currencies). P&L impact would be limited as translation losses on acquisition debt (a large portion of FC exposure) are not routed through the P&L. Valuation impact to the tune of Rs26/share, assuming a Re/US$ rate of 50, is priced in. ADD.

Company data and valuation summary

Bharti Airtel

Stock data			
52-week range (Rs) (high,low)			448-303
Market Cap. (Rs bn)			1,449.0
Shareholding pattern (%)			
Promoters			68.3
FIIs			17.6
MFs			3.7
Price performance (%)	**1M**	**3M**	**12M**
Absolute	(1.9)	1.0	9.4
Rel. to BSE-30	0.3	12.1	27.6

Forecasts/Valuations	2011	2012E	2013E
EPS (Rs)	15.9	18.2	28.0
EPS growth (%)	(32.6)	14.5	53.7
P/E (X)	24.0	20.9	13.6
Sales (Rs bn)	594.7	725.3	842.3
Net profits (Rs bn)	60.5	69.2	106.4
EBITDA (Rs bn)	199.7	254.0	320.7
EV/EBITDA (X)	10.3	8.0	6.0
ROE (%)	13.3	13.3	17.4
Div. Yield (%)	0.0	0.0	0.0

Bharti's FC exposure – some details

Bharti's FY2011 annual report suggests that only about 16% of its total gross debt of Rs621 bn at end-FY2011 was denominated in INR with the rest being non-INR. A majority (Rs454 bn) of this non-INR gross debt of Rs520 bn was in US$ with Nigerian Naira (Rs35 bn) and Japanese Yen (Rs17 bn) contributing a bulk of the rest. In addition to the gross debt on the balance sheet, Bharti also has non-INR currency exposure in the form of current liabilities (primarily equipment payables in US$ and Euro, and some trade creditors). Equipment payables at end-FY2011 stood at Rs65 bn, while trade creditors stood at Rs56 bn. Assuming 100% of equipment payables and 30% of trade creditors are in non-INR currencies, this increases Bharti's non-INR exposure by another Rs82 bn, taking the total exposure including non-INR debt to Rs600 bn or around US$13 bn.

Impact on P&L and valuations should be looked at separately

It is important to look the impact of US$ and JPY strengthening on P&L and valuations separately. Two reasons – (1) 100% impact is not routed through the P&L, and (2) mark-to-market (MTM) impact routed through the P&L is a one-time impact on earnings and hence, multiple-based valuations should exclude the P&L impact and adjust for the valuation impact separately.

P&L impact – what gets routed and what doesn't?

Bharti's FC exposure is at various subsidiary levels, each of which has its own functional currency. There are two legs to translation of FC liabilities into the reporting currency, i.e. INR. In the first leg, FC liabilities are translated into functional currency; for example, US$ debt in Nigeria is translated into Nigerian Naira in this leg. Forex gains/losses on this first leg of translation are routed through the P&L. The second leg of translation restates from functional currencies to the reporting currency, INR. Translation impact of this leg is taken to the balance sheet in the form of foreign currency translation reserve. Bharti had an FCTR balance of Rs12.8 bn as of end-June 2011.

Hence, from a P&L perspective, one does not need to worry about the second leg of translation. This is important because a bulk of FC exposure (almost US$9.5 bn) is at the Netherlands acquisition SPV level. The functional currency of this SPV is US$ and hence, there is no leg-1 translation impact and accordingly, no P&L impact.

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PBT sensitivity – how much could 2QFY12E get hit?

Bharti's FY2011 annual report gives the PBT impact of fluctuation in US$ and JPY versus the Re (at a consolidated level, taking into account the non-designated hedges). **It specifies Rs5.23 bn PBT impact of a 5% move in the Re and Rs1.03 bn impact of a 5% move in the JPY.** This sensitivity applied to the FC exposure composition across currencies as of end-March 2011. This would not have changed materially since, in our view.

Hence, the nearly 5.8% Re depreciation versus US$ and around 11% Re depreciation versus the JPY versus end-June 2011 levels, at the time of writing (actual impact would be determined on the basis of Re/US$ and Re/JPY levels on September 30, 2011), would impact Bharti's PBT by close to Rs8.3 bn. This implies an incremental forex loss of Rs6.6 bn qoq versus Rs1.7 bn in 1QFY12. On our current revenue/EBITDA estimates for the quarter, this could mean a net income just upwards of Rs10 bn for 2QFY12E, down from Rs12.2 bn in 1QFY12. FY2012E earnings go down by nearly 8% to Rs16.7 from the current estimate of Rs18.2. We do note that this impact is MTM and would reverse if Rupee were to appreciate later in the year.

Valuation impact

MTM forex losses on account of adverse currency movements are a one-time hit (unless the currency continues to move adversely) on earnings and hence, a multiple-based valuation should exclude forex gains and losses, in our view. Nonetheless, unhedged FC exposure has a real cost (at some point, even if MTM is only notional at a particular timeframe) if currencies sustain at adverse levels and valuations should reflect that.

A better way to assess the impact on valuations is to (1) look at the increase in INR net debt the FC impact leads to, and (2) compute the present value of higher-than-assumed future interest payments in INR on FC debt assuming Re/US$ sustains at current levels.

For example, assuming Re/US$ at 50 (versus 44.8 at end-June 2011) and similar movements in JPY and other foreign currencies that Bharti is exposed to, the roughly 11.6% adverse movement would lead to an increase of US$1.5 bn on the company's net FC exposure (including current liabilities in FC) of US$13 bn – roughly an impact of Rs20/share. One also needs to add the roughly Rs3.4/share FCTR on the balance sheet as of end-June 2011.

Also, interest payout of roughly US$500 mn per annum assumed for the next five years in our model goes up by roughly 11.6% every year. This translates into a PV impact of US$210 mn or roughly Rs2.8/share. Total impact, assuming Re/US$ goes to 50 and sustains as a long-term level, is Rs26/share. Stock's recent fall largely prices this in, in our view. We remain constructive with a target price of Rs460/share. ADD.

Bharti - currency-wise gross debt as of end-March 2011

Currency	Gross debt (Rs mn)
INR	101
USD	**454**
JPY	**17**
NGN (Naira)	35
XAF	5
Others	8
Total	**621**

Source: Company

Bharti - gross debt break-up as of end-June 2011

Currency	Gross debt (US$ mn)
Bharti India	3,668
Africa - opcos	**454**
Africe - acquisition SPV	**9,584**
Total	**13,707**

Source: Company

Bharti - PBT impact of currency movements

Currency	PBT impact (Rs mn) - FY2011	% of FY2011 PBT
USD +5%	**(5,230)**	**(7)**
JPY +5%	**(1,027)**	**(1)**

Source: Company

Understanding accounting treatment of foreign currency translation gains/losses - some examples

	Functional currency (A)	Liability	Liability currency (B)	Whether foreign?	(B) to (A) translation (Leg 1)	Reporting currency (C)	(A) to (C) translation (Leg 2)
Bharti India							
	INR	USD debt	USD	Yes	Routed to P&L	INR	Not applicable (NA)
	INR	INR debt	INR	No	NA	INR	NA
	INR	EUR creditor	EUR	Yes	Routed to P&L	INR	NA
Netherlands acquisition SPV							
	USD	USD debt	USD	No	NA	INR	Taken to balance sheet (FCTR)
Bharti Nigeria							
	NGN	USD debt	USD	Yes	Routed to P&L	INR	Taken to balance sheet (FCTR)
	NGN	NGN debt	NGN	No	NA	INR	Taken to balance sheet (FCTR)
	NGN	JPY debt	NGN	Yes	Routed to P&L	INR	Taken to balance sheet (FCTR)

Source: Kotak Institutional Equities

Bharti - condensed financials, IFRS, March fiscal year-ends (Rs mn)

	2010	2011	2012E	2013E	2014E
Profit and loss statement					
Revenues	418,472	594,672	725,284	842,251	947,366
EBITDA	167,633	199,664	253,953	320,715	369,183
EBIT	104,798	97,598	122,575	175,994	211,867
PBT	105,136	76,839	95,163	155,694	200,171
Recurring PAT	89,765	60,467	69,210	106,382	133,227
Recurring EPS (Rs/share)	**23.6**	**15.9**	**18.2**	**28.0**	**35.1**
Balance sheet					
Total Equity	447,225	516,231	584,272	694,815	819,348
Borrowings	101,898	616,708	596,708	546,708	451,708
Other liabilities	161,817	332,125	343,224	364,062	379,881
Total equity and liabilities	**710,940**	**1,465,064**	**1,524,205**	**1,605,585**	**1,650,937**
Net fixed assets	482,629	651,426	710,296	752,775	783,292
Net intangibles	59,890	637,317	607,249	577,180	547,112
Cash and equivalents	25,323	9,575	17,575	57,281	77,030
Other assets	143,098	166,746	189,085	218,348	243,504
Total assets	**710,940**	**1,465,064**	**1,524,205**	**1,605,585**	**1,650,937**
Cash flow statement					
Operating cash flow	191,538	283,473	215,592	267,139	299,794
Capex	(130,582)	(142,190)	(160,180)	(157,132)	(157,763)
Free cash flow	**60,955**	**141,283**	**55,412**	**110,006**	**142,031**
Acquisitions	(75,675)	(706,100)	—	—	—
Borrowings	(16,903)	514,810	(20,000)	(50,000)	(95,000)
Others	45,801	34,259	(27,412)	(20,300)	(27,283)
Total change in cash balances	**14,178**	**(15,748)**	**8,000**	**39,706**	**19,748**
Ratios (%)					
Sales growth	13.2	42.1	22.0	16.1	12.5
EBITDA growth	10.6	19.1	27.2	26.3	15.1
EPS growth	5.8	(32.6)	14.5	53.7	25.2
FCF growth		131.8	(60.8)	98.5	29.1
EBITDA margin	**40.1**	**33.6**	**35.0**	**38.1**	**39.0**
Net margin	21.5	10.2	9.5	12.6	14.1
FCF margin	14.6	23.8	7.6	13.1	15.0
RoAE		12.6	12.6	16.6	17.6
ROAE (excl. cash and int. income)					
RoACE		9.2	7.7	10.8	12.6
ROACE (excl. cash and int. income)					
Net debt/EBITDA (X)	0.5	3.0	2.3	1.5	1.0
Net debt/equity (X)	0.2	1.2	1.0	0.7	0.5
Total debt/capital (X)	0.2	0.5	0.5	0.4	0.4

Source: Company, Kotak Institutional Equities estimates

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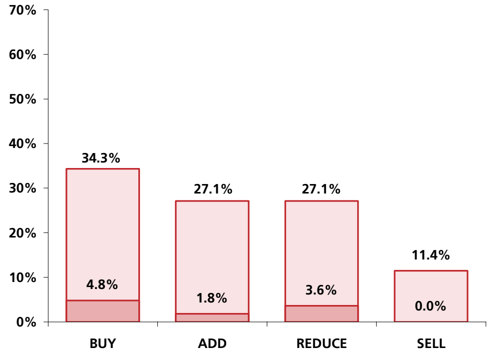

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Source: Kotak Institutional Equities

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