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Updates

Bharti Airtel, Idea Cellular, Reliance Communications: Blue corner versus red corner may put you in a tight corner; start boxing practice now

News Roundup

Corporate

- Orient Express has denied entering into any strategic discussions with Indian Hotels. The company has replied to Indian Hotels that it does not wish to pursue any strategic discussions with Indian Hotels. *(ET)*
- Infosys may put up a €4.6 bn bid for UK based accounting software company Sage. Microsoft, Intuit and Goldman Sachs are believed to be the other suitors for the same *(ET)*
- GVK and Reliance group are said to be in talks for a strategic alliance for the proposed Navi Mumbai airport. Various options are being considered, including Reliance group picking up a stake in MIAL- the Mumbai airport operator. *(ET)*
- BPCL plans to submit a \$350 mn non-binding bid to acquire a 10% interest in the M'Boundi oil field in the Republic of Congo *(FE)*

Economic and political

- The Federal Reserve cut interest rates by 50 basis points to prevent a possible recession in the US economy *(BS)*
- The government has re-invited bids for the ultra mega power project at Tilaiya in Jharkhand. This has been done to accommodate the new tighter norms for eligibility introduced after the dispute over the Sasan project. *(BS)*
- Finance ministry has notified a scheme to refund the 4% additional customs duty paid on electronic items. Traders who import the goods will have to provide proof of payment of sales tax or VAT in order to claim the refund. Earlier both sales tax and additional customs duty was being charged. *(BS)*

Source: ET = Economic Times, BS = Business Standard, FE = Financial Express, BL = Business Line.

EQUITY MARKETS

India	Change, %			
	18-Sep	1-day	1-mo	3-mo
Sensex	15,669	1.1	10.8	9.6
Nifty	4,546	1.1	10.7	7.9
Global/Regional indices				
Dow Jones	13,739	2.5	5.0	0.8
Nasdaq Composite	2,652	2.7	5.9	0.9
FTSE	6,283	1.6	3.6	(5.5)
Nikkei	16,333	3.4	6.9	(10.1)
Hang Seng	25,345	3.1	24.3	17.4
KOSPI	1,890	2.8	15.4	4.6
Value traded - India				
		Moving avg, Rs bn		
	18-Sep	1-mo	3-mo	
Cash (NSE+BSE)	163.1	152.6	160.1	
Derivatives (NSE)	449.6	648.8	307.9	
Deri. open interest	883.4	870.2	699.8	

Forex/money market

	Change, basis points			
	18-Sep	1-day	1-mo	3-mo
Rs/US\$	40.5	-	(47)	(23)
6mo fwd prem, %	0.7	(25)	71	24
10yr govt bond, %	7.9	3	(11)	(28)

Net investment (US\$m)

	17-Sep	MTD	CYTD
FIs	(66)	1,052	9,426
MFs	(50)	(66)	692

Top movers -3mo basis

Best performers	Change, %			
	18-Sep	1-day	1-mo	3-mo
Reliance Energy	927	2.1	28.8	73.0
Neyveli Lignite	96	(3.5)	26.6	59.9
Chambal Fert	50	0.7	33.7	46.6
Reliance Cap	1,446	4.8	43.9	34.2
IDBI	135	1.7	16.3	34.6
Worst performers				
Polaris	116	-	(1.2)	(26.3)
i-Flex	1,895	(0.8)	(1.5)	(25.4)
Punjab Tractors	238	(0.7)	(3.7)	(19.2)
Cipla	169	(2.0)	(8.1)	(18.8)
Novartis India	292	(0.7)	(2.5)	(16.0)

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Telecom

Sector coverage view

Cautious

Company	Rating	Price, Rs	
		18-Sep	Target
Bharti	U	833	750
Rcom	U	537	500
Idea Cellular	U	120	110

Bharti Airtel, Idea Cellular, Reliance Communications : Blue corner versus red corner may put you in a tight corner; start boxing practice now

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- **Government can change policy any time; best to prepare for any major negative development**
- **RCOM probably best positioned in spectrum battle, MNP; position your investments accordingly**
- **However, pricing risks exist whichever way spectrum issue gets resolved**

We analyze possible scenarios arising from potential regulatory and political developments and conclude that RCOM may be best positioned in most scenarios. We note that the government has the prerogative to change policies and regulations at any time and we would not simply hope and pray for a favorable resolution of the spectrum debate. We advocate investors realign their telecom investments (if they still desire exposure to the Indian wireless sector) keeping in light potential developments. Our pecking order is RCOM, Bharti and Idea as we expect future developments on spectrum allocation policy and implementation of MNP to benefit RCOM more than others. In any case, there is not much to choose in terms of valuations of the three stocks; all three have similar downside to our 12-month target prices based on DCF (Rs750 for Bharti, Rs500 for RCOM and Rs110 for Idea). Our earnings and valuations models factor in a very benign pricing environment and timely execution of planned expansions of operators without any spectrum availability issues.

Spectrum 'end-game' uncertain but RCOM in better position versus others;

uncertain political environment adds to uncertainty. An uncertain political environment and deep-seated positions and vested interests of the Indian wireless operators make it difficult for us to take a firm stance on the spectrum issue. We are also perturbed by the move of the industry (COAI, GSM association) to contest the revised spectrum allocation policy. We see RCOM as the best positioned among the operators in various possible scenarios discussed below.

- 1. Early national elections take place and spectrum issue remains unresolved for a long time (12-15 months).** We believe the government is unlikely to take a decision on the spectrum allocation policy close to elections assuming national elections take place ahead of schedule. Thus, early elections would result in delay of issue of spectrum to all operators and will be a negative for all operators from a capex perspective. However, incumbent operators such as Bharti, RCOM, BSNL and Vodafone (in its extant 16 circles) would be at an advantage versus other operators (Idea, Airtel, Spice); the latter set requires spectrum to start operations in new circles. Bharti and RCOM can utilize their existing spectrum to grow their subscriber base albeit at higher capex; in particular, RCOM can grow its CDMA business with relatively lesser difficulty versus others. Aspiring operators without spectrum would not be in a position to start operations and may have to contend with relatively saturated markets by the time they receive spectrum and start operations.
- 2. Government accepts revised spectrum policy proposed by the regulator and releases additional spectrum under the revised policy.** If the government releases additional 15-20 MHz spectrum under the revised spectrum allocation policy, we expect 'new' operators to receive 4.4 MHz (X2) spectrum per circle and incumbent operators to receive additional spectrum in a few circles only. We expect Airtel, Vodafone, Idea, Spice and RCOM to receive spectrum in the circles where they have already received licenses or have applied for licenses. Exhibit 1 gives our expected priority order for issue of new spectrum by the government.

3. Implementation of MNP, if and when implemented, may give RCOM an advantage over others. We believe that eventual implementation of MNP along with issue of GSM spectrum to 'new' players including RCOM will be a large negative development for the sector. We expect pricing to come under pressure and SG&A costs to increase.

However, we expect RCOM to be in a relatively better position versus others even under a MNP scenario. RCOM can churn out extant GSM subscribers of incumbent operators under MNP while largely retaining its CDMA subscriber. A CDMA subscriber of RCOM will not be in a position to migrate to a GSM operator (technology compatibility issues). A CDMA subscriber would have limited options to migrate given fewer (two only) number of CDMA players.

Valuations—no need to get excited unless profitability surprises on the upside.

Despite the stocks under-performance over the past six months, we do not think valuations are attractive enough to factor in potential risks from potential (1) unfavorable regulatory developments and (2) deterioration in pricing. We assume very benign operating conditions in perpetuity. We model very high ROCE in the terminal year of our forecasts and throughout our explicit our forecast period as shown in Exhibit 2. However, the same exhibit shows the severe impact of a decline in prices (ARPU or RPM) on our 12-month fair valuations of the stocks. Exhibit 3 shows the impact of lower pricing on EPS. We note that current ROCI of all telecom operators is very high, which provides ample scope for deterioration in pricing. Exhibit 4 shows CROCI of Indian wireless operators.

August net wireless additions at 8.3 mn. The Indian wireless market added 8.3 mn subs in August 2007 up from 7.95 mn in July 2007. As discussed in our September 14 note, the acceleration in monthly additions reflects aggressive roll-out by operators. However, we would highlight the rising and reasonably high penetration in certain circles (see Exhibit 5). The latter raises issues about the pace of additions 3-4 quarters hence. A likely slowdown in subscriber additions coupled with factors discussed above (entry of more players, MNP) may put additional pressure on pricing.

RCOM and Idea likely to get GSM spectrum assuming 20 Mhz spectrum is released by the defence department and TRAI's revised spectrum policy is accepted
New entrants and likely order of receipt of spectrum based on chronological order

	Bharti	Reliance	BSNL/MTNL	VOD/Essar	Idea	TTSL	Aircel	Spice	Others
Metro									
Calcutta					2		1	3	
Chennai		3			1			2	
Delhi		3					1	2	
Mumbai		4			2		1	3	
Circle A									
Andhra Pradesh		3					1	2	
Gujarat		3					1	2	
Karnataka		3			2		1		
Maharashtra		3					1	2	
Tamil Nadu		3			1			2	
Circle B									
Haryana		3					1	2	
Kerala		3					1	2	
Madhya Pradesh				2			1	3	
Punjab		3			2		1		
Rajasthan		3					1	2	
Uttar Pradesh (east)		3					1	2	
Uttar Pradesh (west)		3					1	2	
West Bengal and A&N islands					2			3	1
Circle C									
Assam				1	3			4	2
Bihar				1	2			4	3
Himachal Pradesh				1				2	
North East				1	2			4	3
Orissa				1	2			4	3
J&K				1	2			3	

Existing operations
License acquired but spectrum not available
License applied for
Existing CDMA operations, GSM spectrum applied for

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

Idea has higher leverage to pricing than RCOM and Bharti

Valuation sensitivity to change in pricing

	Change in pricing from base case						
	-15%	-10%	-5%	Base case	5%	10%	15%
12-month forward DCF valuation (Rs)							
Bharti	543	585	626	668	710	752	794
Idea	75	87	100	112	125	138	152
RCL	355	390	426	461	497	532	568
RoACE in terminal year, FY2017E (%)							
Bharti	46	48	50	52	54	56	58
Idea	25	26	27	28	30	31	32
RCL	17	18	19	21	22	23	25

Note:

- Lower sensitivity of RCL versus peers reflects a lower proportion of revenues from wireless.
- Valuations of Bharti and Reliance are for the core business only.

Source: Kotak Institutional Equities estimates.

Idea's earnings estimates are the most sensitive to changes in pricing assumptions

EPS sensitivity to change in pricing assumption, 2008E-2009E

	Change in pricing from base case						
	-15%	-10%	-5%	Base case	5%	10%	15%
2008E EPS (Rs)							
Bharti	31.0	32.2	33.4	34.5	35.7	36.9	38.1
Idea	3.3	3.8	4.4	4.9	5.5	6.0	6.6
RCL	19.7	21.1	22.5	23.9	25.4	26.8	28.2
2009E (EPS)							
Bharti	41.5	43.0	44.4	45.9	47.4	49.0	50.5
Idea	4.6	5.0	5.5	6.0	6.6	7.2	7.7
RCL	25.9	27.9	30.0	32.1	34.2	36.3	38.3

Note:

(a) Lower sensitivity of RCL versus peers reflects a lower proportion of revenues from wireless.

(b) Valuations of Bharti and Reliance are for the core business only.

Source: Kotak Institutional Equities estimates.

The wireless business in India generates remarkably high CROCI, which provides sufficient scope for weaker pricing

CROCI of wireless segment of Bharti, Idea and RCL (%)

	Jun-05	Sep-05	Dec-05	Mar-06	Jun-06	Sep-06	Dec-06	Mar-07	Jun-07
Bharti Airtel									
EBIT (Rs mn)	3,932	4,341	5,319	5,522	6,961	8,085	9,184	11,424	13,321
Tax rate (%)	13.6	8.9	13.4	7.4	11.1	12.8	14.8	9.0	19.0
EBIT*(1-t) (Rs mn)	3,396	3,956	4,604	5,113	6,190	7,052	7,821	10,398	10,788
Add: Depreciation	2,141	2,608	2,613	3,224	3,380	4,094	4,945	5,180	5,766
Cash return (Rs mn)	5,537	6,564	7,217	8,337	9,570	11,146	12,766	15,578	16,554
Annualized cash return (Rs mn)	22,148	26,256	28,870	33,348	38,281	44,582	51,063	62,313	66,216
Gross cash invested (Rs mn)	124,643	133,258	141,555	159,227	177,633	205,084	220,672	231,414	264,494
CROCI (%)	17.8	19.7	20.4	20.9	21.6	21.7	23.1	26.9	25.0
Idea Cellular									
EBIT (Rs mn)							1,905	2,599	3,241
Tax rate (%)							3.2	1.0	0.5
EBIT*(1-t) (Rs mn)							1,845	2,573	3,224
Add: Depreciation							1,801	1,761	1,887
Cash return (Rs mn)							3,646	4,334	5,111
Annualized cash return (Rs mn)							14,584	17,336	20,446
Gross cash invested (Rs mn)							66,187	75,105	79,201
CROCI (%)							22.0	23.1	25.8
Reliance Communications									
EBIT (Rs mn)					3,998	5,131	5,542	6,991	9,284
Tax rate (%)					5.0	0.8	1.4	1.4	7.8
EBIT*(1-t) (Rs mn)					3,797	5,088	5,465	6,891	8,561
Add: Depreciation					3,573	4,163	4,751	4,520	4,108
Cash return (Rs mn)					7,370	9,251	10,216	11,411	12,669
Annualized cash return (Rs mn)					29,478	37,004	40,864	45,642	50,676
Gross cash invested (Rs mn)					155,117	170,100	182,190	192,050	207,023
CROCI (%)					19.0	21.8	22.4	23.8	24.5

Source: Companies, Kotak Institutional Equities estimates.

Wireless operators in India and total subscribers, end-August 2007 ('000)

	Bharti	Reliance	BSNL	Hutch	IDEA	TTSL	Aircel	MTNL	Spice	BPL	Others	Total	Penetration
Total subs - August 2007	46,815	34,525	29,704	34,115	17,871	14,323	7,621	2,835	3,398	1,102	116	192,424	(%)
Current mobile market share (%)	24.3%	17.9%	15.4%	17.7%	9.3%	7.4%	4.0%	1.5%	1.8%	0.6%	0.1%	100%	17.3
Metro													
Calcutta	1,330	1,395	762	1,523		753						5,762	33.5
Chennai	1,262	721	846	897		172	1,453					5,350	71.3
Delhi	3,420	1,894		2,821	1,720	2,091		1,264				13,211	63.5
Mumbai	2,101	2,106		2,822		959		1,570		1,102		10,660	47.1
Circle A													
Andhra Pradesh	4,553	3,004	1,977	1,928	2,400	1,521						15,382	18.9
Gujarat	1,903	2,001	1,464	4,932	2,001	560						12,862	22.9
Karnataka	5,374	1,948	1,677	2,160		667		1,211				13,037	22.7
Maharashtra	3,136	2,370	2,535	1,631	3,601	1,435						14,709	17.0
Tamil Nadu	2,825	2,118	2,086	1,811		347	3,792					12,978	21.6
Circle B													
Haryana	847	608	1,194	1,061	909	561						5,181	26.8
Kerala	1,238	1,587	1,979	1,351	2,034	419						8,606	25.4
Madhya Pradesh	2,004	2,750	1,391		2,100	438						8,683	9.6
Punjab	2,819	799	1,338	1,470		569		2,187		79		9,262	33.7
Rajasthan	2,548	1,311	2,171	2,079	606	951				36		9,702	15.3
Uttar Pradesh (east)	2,133	2,278	3,105	3,507	602	648						12,273	10.0
Uttar Pradesh (west)	1,252	1,672	1,687	2,162	1,858	892						9,522	13.2
West Bengal and A&N islands	1,302	1,387	1,091	1,960		403	289					6,431	9.1
Circle C													
Assam	707	580	570				858					2,715	9.3
Bihar	3,109	2,575	1,245			571	244					7,744	6.3
Himachal Pradesh	678	333	496		41	89	20					1,658	25.1
North East	332	214	483				454					1,483	10.6
Orissa	1,261	875	808			276	367					3,587	9.0
J&K	681		800				144					1,626	14.4

Note:

(a) Subscriber numbers exclude RCL GSM net adds for August 2007

Source: COAI, AUSPI, Compiled by Kotak Institutional Equities.

Subscriber details for leading wireless operators, ('000)

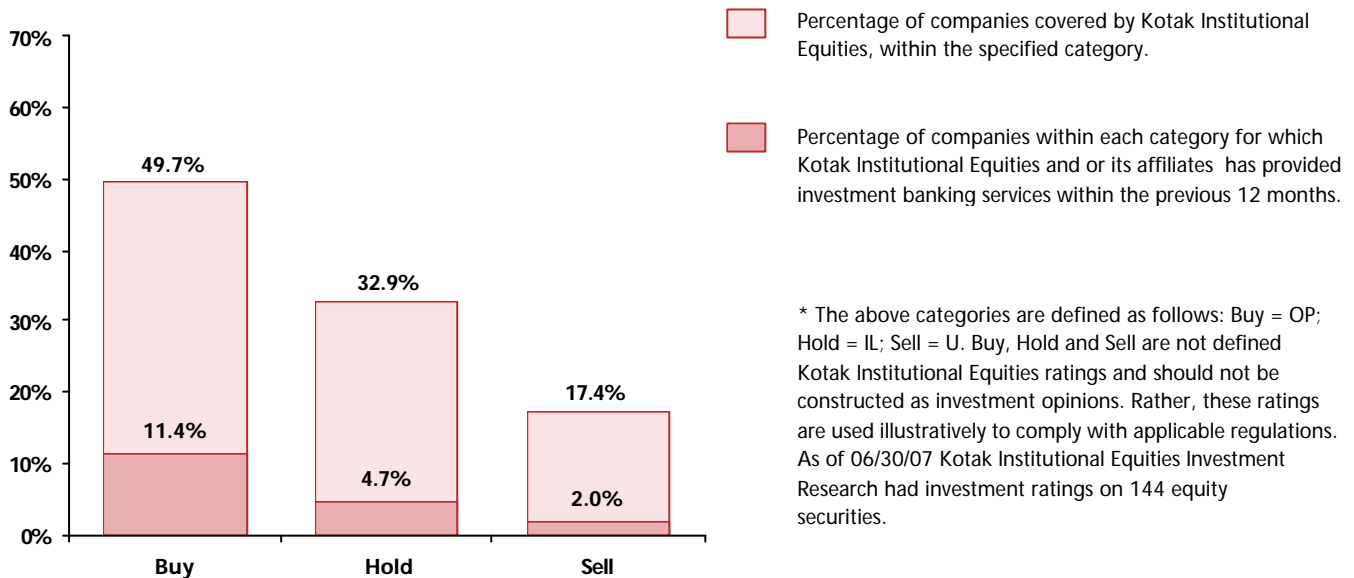
	Aug-06	Sep-06	Oct-06	Nov-06	Dec-06	Jan-07	Feb-07	Mar-07	Apr-07	May-07	Jun-07	Jul-07	Aug-07
Subs ('000)													
Reliance	24,776	25,979	27,232	28,584	27,720	31,388	32,395	28,968	29,027	30,429	31,869	33,344	34,525
Bharti	25,649	27,061	28,612	30,262	31,974	33,732	35,440	37,141	38,892	40,744	42,704	44,763	46,815
BSNL	20,063	20,936	22,054	22,975	23,619	24,442	25,444	27,429	27,756	27,994	28,423	28,979	29,704
Hutchison	19,380	20,357	21,267	22,275	23,306	24,414	25,343	26,442	27,703	29,209	30,752	32,437	34,115
IDEA	9,735	10,364	10,980	11,841	12,442	13,072	13,640	14,011	14,563	15,267	16,126	17,004	17,871
BPL	1,043	1,045	1,049	1,053	1,056	1,062	1,066	1,071	1,077	1,082	1,088	1,095	1,102
Spice group	2,148	2,197	2,266	2,357	2,450	2,520	2,579	2,729	2,815	3,007	3,170	3,290	3,398
TTSL	7,795	8,435	9,319	9,786	10,453	10,712	11,091	11,433	11,639	11,989	12,747	13,512	14,323
MTNL	2,370	2,396	2,431	2,481	2,530	2,604	2,684	2,852	2,589	2,654	2,714	2,775	2,835
Others	3,689	3,896	4,101	4,336	4,600	4,909	5,205	5,619	6,036	6,518	6,887	7,276	7,736
Total market	116,647	122,667	129,311	135,951	140,151	148,855	154,887	157,695	162,098	168,894	176,481	184,474	192,424
Market share of subs (%)													
Reliance	21.2	21.2	21.1	21.0	19.8	21.1	20.9	18.4	17.9	18.0	18.1	18.1	17.9
Bharti	22.0	22.1	22.1	22.3	22.8	22.7	22.9	23.6	24.0	24.1	24.2	24.3	24.3
BSNL	17.2	17.1	17.1	16.9	16.9	16.4	16.4	17.4	17.1	16.6	16.1	15.7	15.4
Hutchison	16.6	16.6	16.4	16.4	16.6	16.4	16.4	16.8	17.1	17.3	17.4	17.6	17.7
IDEA	8.3	8.4	8.5	8.7	8.9	8.8	8.8	8.9	9.0	9.0	9.1	9.2	9.3
BPL	0.9	0.9	0.8	0.8	0.8	0.7	0.7	0.7	0.7	0.6	0.6	0.6	0.6
Spice group	1.8	1.8	1.8	1.7	1.7	1.7	1.7	1.7	1.7	1.8	1.8	1.8	1.8
TTSL	6.7	6.9	7.2	7.2	7.5	7.2	7.2	7.3	7.2	7.1	7.2	7.3	7.4
MTNL	2.0	2.0	1.9	1.8	1.8	1.7	1.7	1.8	1.6	1.6	1.5	1.5	1.5
Others	3.2	3.2	3.2	3.2	3.3	3.3	3.4	3.6	3.7	3.9	3.9	3.9	4.0
Net monthly adds ('000)													
Reliance	1,152	1,204	1,253	1,352	(864)	3,667	1,007	(3,427)	60	1,401	1,440	1,475	1,181
Bharti	1,311	1,413	1,551	1,650	1,712	1,758	1,708	1,701	1,751	1,851	1,960	2,059	2,051
BSNL	1,032	873	1,118	921	643	824	1,002	1,985	327	239	429	556	725
Hutchison	981	977	910	1,008	1,032	1,108	929	1,099	1,261	1,506	1,542	1,686	1,678
IDEA	613	629	616	862	601	629	568	371	553	703	860	878	867
BPL	(242)	3	4	4	4	6	4	5	6	5	6	7	7
Spice group	53	49	69	91	92	70	59	150	86	192	163	120	107
TTSL	705	640	884	467	667	259	379	342	206	350	758	764	812
MTNL	26	26	35	49	50	74	81	168	(263)	64	61	60	60
Others	211	207	205	235	265	308	296	415	416	483	368	389	461
Total market	5,844	6,020	6,644	6,640	4,201	8,704	6,032	2,808	4,403	6,796	7,587	7,993	7,950
Market share of net adds (%)													
Reliance	19.7	20.0	18.9	20.4	(20.6)	42.1	16.7	(122.0)	1.4	20.6	19.0	18.5	14.9
Bharti	22.4	23.5	23.3	24.9	40.7	20.2	28.3	60.6	39.8	27.2	25.8	25.8	25.8
BSNL	17.7	14.5	16.8	13.9	15.3	9.5	16.6	70.7	7.4	3.5	5.7	7.0	9.1
Hutchison	16.8	16.2	13.7	15.2	24.6	12.7	15.4	39.1	28.6	22.2	20.3	21.1	21.1
IDEA	10.5	10.4	9.3	13.0	14.3	7.2	9.4	13.2	12.6	10.4	11.3	11.0	10.9
BPL	(4.1)	0.0	0.1	0.1	0.1	0.1	0.1	0.2	0.1	0.1	0.1	0.1	0.1
Spice group	0.9	0.8	1.0	1.4	2.2	0.8	1.0	5.4	1.9	2.8	2.2	1.5	1.3
TTSL	12.1	10.6	13.3	7.0	15.9	3.0	6.3	12.2	4.7	5.1	10.0	9.6	10.2
MTNL	0.4	0.4	0.5	0.7	1.2	0.8	1.3	6.0	(6.0)	0.9	0.8	0.8	0.8
Others	3.6	3.4	3.1	3.5	6.3	3.5	4.9	14.8	9.5	7.1	4.9	4.9	5.8
Circlewise subs ('000)													
Metros	25,636	26,444	27,202	27,851	28,736	29,591	30,505	30,243	30,565	31,501	32,573	33,815	34,984
Circle A	41,195	43,598	46,113	48,653	50,694	53,129	55,011	55,809	57,961	60,278	62,792	65,713	68,967
Circle B	39,810	42,000	44,662	47,335	47,857	52,515	54,890	56,236	57,740	60,414	63,587	66,722	69,661
Circle C	10,005	10,625	11,334	12,111	12,864	13,620	14,480	15,406	15,831	16,700	17,530	18,225	18,812
Total	116,647	122,667	129,311	135,951	140,151	148,855	154,887	157,695	162,098	168,894	176,481	184,474	192,424
Circlewise net adds ('000)													
Metros	586	807	758	648	885	855	914	(262)	322	936	1,072	1,242	1,169
Circle A	2,068	2,403	2,515	2,540	2,041	2,435	1,882	798	2,153	2,317	2,513	2,921	3,255
Circle B	2,623	2,190	2,662	2,673	522	4,657	2,375	1,346	1,504	2,674	3,173	3,136	2,938
Circle C	566	620	708	778	752	756	860	926	425	869	829	695	587
Total	5,844	6,020	6,644	6,640	4,201	8,704	6,032	2,808	4,403	6,796	7,587	7,993	7,950
Circlewise subs (%)													
Metros	22	22	21	20	21	20	20	19	19	19	18	18	18
Circle A	35	36	36	36	36	36	36	35	36	36	36	36	36
Circle B	34	34	35	35	34	35	35	36	36	36	36	36	36
Circle C	9	9	9	9	9	9	9	10	10	10	10	10	10
Circlewise net adds (%)													
Metros	10	13	11	10	21	10	15	(9)	7	14	14	16	15
Circle A	35	40	38	38	49	28	31	28	49	34	33	37	41
Circle B	45	36	40	40	12	54	39	48	34	39	42	39	37
Circle C	10	10	11	12	18	9	14	33	10	13	11	9	7
GSM CDMA split													
GSM	86,620	91,014	95,742	100,786	105,425	110,420	115,297	121,431	124,843	130,124	135,787	141,839	147,793
CDMA	30,027	31,654	33,569	35,164	34,726	38,435	39,590	36,263	37,255	38,769	40,694	42,636	44,631

Source: COAI, AUSPI, Compiled by Kotak Institutional Equities.

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Source: Kotak Institutional Equities.

As of June 30, 2007

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