

Company Focus

11 October 2007 | 8 pages

Spice Communications (SPCM.BO)

 Estimate change

Buy: 3Q07 – Margin Improvement, but Net Below Expectations

- EBITDA margin a positive surprise** — 3Q07 revenue at Rs2,522m was in line with EBITDA at Rs614m, providing the positive surprise – led mainly by stable to declining SG&A expenses. The EBITDA margin expanded by a robust 350bp qoq. This was however offset by lower-than-expected other income, resulting in recurring net profit at only Rs31m. Exceptionals of Rs11.6m resulted in a reported loss at the net level.
- Modifying estimates to align quarterlies** — We upgrade CY07 EBITDA by 3% but adjust CY08-09 estimates downwards by 4-5% to factor in more conservative sub adds albeit at higher EBITDA margins. Other assumptions relating to ARPU, MoU and capex payback period remain broadly similar. Higher tenancy on third-party towers (on which Spice is anchor tenant now) will also aid margin improvement.
- Margin improvement, a trend to watch in Sep quarter**— Expected margin improvements in the quarter under review and beyond was one of the key reasons for our recent upgrade of the frontline stocks. Spice's results could therefore be an indication of things to come.
- Maintain Buy/Medium Risk** — Access to the 900 MHz spectrum and small footprint make Spice an M&A target, in our view. Though new spectrum recommendations may dilute its attractiveness, it opens up the organic route for growth on the flip side, albeit constrained by balance sheet size. Our target price of Rs70 (incl. 15% M&A premium to DCF) remains unchanged.

Buy/Medium Risk	1M
Price (11 Oct 07)	Rs53.50
Target price	Rs70.00
Expected share price return	30.8%
Expected dividend yield	0.0%
Expected total return	30.8%
Market Cap	Rs36,911M US\$943M

Price Performance (RIC: SPCM.BO, BB: SPCM IN)

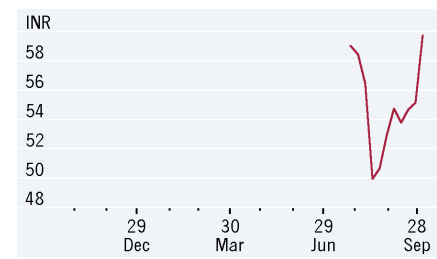


Figure 1. Statistical abstract

	Revenue (Rs m)	EBITDA (Rs m)	Net Profit (Rs m)	FD EPS (Rs)	P/E (x)	EV/EBITDA (x)
Jun 04-May 05	6,066	1,665	74	0.1	NA	25.1
Jun 05-Dec 06	10,466	2,353	(1,105)	(2.0)	NA	30.5
CY07E	9,738	2,307	46	0.1	NA	20.7
CY08E	13,271	3,536	718	1.0	57.7	14.1
CY09E	16,315	4,826	1,571	2.3	26.4	10.4

Source: Company and Citi Investment Research estimates

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Fiscal year end 31-Dec	Jul04-Jun05	Jul05-Dec06	2007E	2008E	2009E
Valuation Ratios					
P/E adjusted (x)	nm	nm	nm	53.3	24.3
EV/EBITDA adjusted (x)	28.2	30.5	19.9	12.8	9.6
P/BV (x)	nm	nm	7.6	6.6	5.2
Dividend yield (%)	0.0	0.0	0.0	0.0	0.0
Per Share Data (Rs)					
EPS adjusted	0.13	-2.00	0.07	1.04	2.28
EPS reported	0.13	-2.00	0.07	1.04	2.28
BVPS	-0.40	-2.40	7.31	8.35	10.63
DPS	0.00	0.00	0.00	0.00	0.00
Profit & Loss (RsM)					
Net sales	6,066	10,466	9,738	13,271	16,315
Operating expenses	-5,640	-10,281	-9,009	-11,908	-14,001
EBIT	426	185	729	1,364	2,313
Net interest expense	-350	-1,231	-679	-641	-738
Non-operating/exceptionals	0	-41	0	0	0
Pre-tax profit	76	-1,087	51	722	1,576
Tax	-2	-18	-5	-5	-5
Extraord./Min.Int./Pref.div.	0	0	0	0	0
Reported net income	74	-1,105	46	718	1,571
Adjusted earnings	74	-1,105	46	718	1,571
Adjusted EBITDA	1,665	2,353	2,307	3,536	4,826
Growth Rates (%)					
Sales	13.1	15.0	39.6	36.3	22.9
EBIT adjusted	58.2	-71.0	491.3	87.0	69.6
EBITDA adjusted	10.7	-5.8	47.1	53.3	36.5
EPS adjusted	-132.8	-1,097.4	-105.2	1,468.6	118.9
Cash Flow (RsM)					
Operating cash flow	1,468	2,108	2,490	3,786	4,812
Depreciation/amortization	1,239	2,168	1,577	2,173	2,513
Net working capital	358	-316	331	301	7
Investing cash flow	-1,195	-3,345	-3,899	-5,066	-4,538
Capital expenditure	-1,243	-3,416	-3,899	-5,066	-4,538
Acquisitions/disposals	0	7	0	0	0
Financing cash flow	-248	411	1,444	359	262
Borrowings	56	1,105	-4,200	1,000	1,000
Dividends paid	0	0	0	0	0
Change in cash	26	-826	34	-921	536
Balance Sheet (RsM)					
Total assets	12,468	13,380	16,073	18,421	21,180
Cash & cash equivalent	2,099	1,273	1,450	575	1,128
Accounts receivable	598	545	636	764	826
Net fixed assets	9,001	10,377	12,698	15,592	17,617
Total liabilities	12,468	13,380	11,029	12,659	13,848
Accounts payable	1,925	2,625	0	0	0
Total Debt	10,762	12,079	7,879	8,879	9,879
Shareholders' funds	-219	-1,324	5,044	5,762	7,332
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	27.4	22.5	23.7	26.6	29.6
ROE adjusted	-28.9	36.1	-4.9	13.3	24.0
ROIC adjusted	5.0	1.0	4.0	10.9	15.6
Net debt to equity	na	na	127.5	144.1	119.4
Total debt to capital	102.1	112.3	61.0	60.6	57.4

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Quarterly performance

Figure 2. Quarterly data

	Jun-06	Sep-06	Dec-06	Mar-07	Jun-07	Sep-07	QoQ (%)	YoY (%)	Comments
Subs (000)	2,055	2,197	2,450	2,729	3,170	3,482	16.2	54.3	104k monthly net adds during the quarter
ARPU (Rs) CIR Estimate	295	286	291	275	262	253	(4.8)	(11.2)	QoQ drop lower than expected
Total revenue	1,764	1,824	2,027	2,137	2,317	2,522	8.4	31.4	
Network Operating costs	579	728	852	673	725	777	7.8	25.4	
Leased charges on passive infra	21	-	-	183	203	216	11.0	NM	Higher tenancy on 3rd party towercos to support margins
Staff +SGA	610	597	618	582	680	672	17.0	11.5	
License fees	154	97	113	188	208	223	10.4	35.1	
Handset costs	-	-	-	34	18	16	(47.0)	NM	
EBITDA	400	402	445	477	483	614	1.2	20.7	Surprised on the positive
PBT	(106)	(254)	(159)	(143)	7	34	NM	NM	
PAT	(109)	(255)	(163)	(147)	4	31	NM	NM	

Source: Citi Investment Research, Company data

Earnings revision

What's changed?

We are modifying our estimates to align quarterlies. Our new EBITDA estimates (+3 to -5%) factor in lower monthly net adds (as seen in 2Q07 additions) though accompanied by higher margins (like 2Q) as rising tenancy on the third-party towercos will increasingly support the EBITDA margin.

Figure 3. Revising estimates

	CY07E	CY08E	CY09E	2 year CAGR (CY07-09)
Subscribers				
Old	4,080	5,825	7,243	
New	3,767	5,280	6,612	32.5%
Change (%)	-7.7%	-9.4%	-8.7%	
YoY change (%)		40.2%	25.2%	
EBITDA				
Old	2,245	3,668	5,051	
New	2,307	3,536	4,826	44.6%
Change (%)	2.7%	-3.6%	-4.5%	
YoY change (%)		53.3%	36.5%	
EBITDA margins				
Old	21.5%	24.8%	27.7%	
New	23.7%	26.6%	29.6%	
Change	2.2%	1.8%	1.9%	

Source: Citi Investment Research estimates

What remains unchanged

Figure 4. Key Operating Assumptions Remain Broadly Unchanged

	CY07E	CY08E	CY09E
ARPU			
Old	266	248	232
New	260	244	228
% change	-2.1%	-1.7%	-1.8%
MoU			
Old	386	407	418
New	387	409	419
% change	0.2%	0.4%	0.3%
Rev/min			
Old	0.69	0.61	0.56
New	0.67	0.60	0.54
% change	-2.3%	-2.0%	-2.1%

Source: Citi Investment Research estimates

Spice Communications

Company description

Spice Communications, a pure-play regional wireless provider, is the seventh-largest cellular operator in India and provides services in two circles — Punjab and Karnataka — where it is the incumbent operator. It commenced services in 1996 and listed on the Bombay Stock Exchange (BSE) in July 2007. It is majority owned by the Dilip Modi group and Telekom Malaysia.

Investment strategy

We rate Spice Buy/Medium Risk. Continued robust wireless market expansion and presence in fast growing markets - Punjab (33% penetration) and Karnataka (22%) - offers growth potential as it moves to bolster its inadequate market share in the latter (~9%). This is evident from the recent pick-up in Spice's share of net adds. The company's recent IPO has provided sufficient funding flexibility to pursue its growth plans, at least in these two circles as Spice currently does not face any spectrum constraints. We estimate EBITDA CAGR of 45% over CY06-09E, ahead of all listed peers and more than double that of the broader market. In addition, we believe that Spice's spectrum allocation in the more efficient 900 MHz band and smaller footprint offers good M&A potential in the long run. From an industry perspective, we believe that low revenue yields and moderate EBITDA margins leave little room for disruptive pricing.

Valuation

Our target price of Rs70 is based on a 15% M&A premium to our core business DCF of Rs60 (as on Dec-08). We prefer DCF as our primary valuation methodology due to the back-ended nature of free cash flows, in the context of coverage ramp-up, especially in Karnataka. Our DCF assumes a WACC of 11% at a target debt to capital of 50.0% and terminal growth rate of 4.0% (similar to Bharti). Our DCF is based on explicit forecasts for CY07-16E with a terminal year EBITDA margin at 35% (~600bps below Idea) and capex/sales of ~7% (in line with Bharti). The target price implies a CY08E EV/EBITDA of 14.1x (which is 5% premium on pro-rata basis to Bharti's FY09 target ex-towerco), which we believe is supported by significantly higher prospective EBITDA growth rates for Spice. Though Spice rebuffed the moves by Idea pre-IPO, we believe that M&A potential exists in the medium term as access to 900MHz spectrum and its small footprint makes it a good and probably the only M&A candidate, especially with recent relaxation of M&A norms. If the new TRAI spectrum norms are accepted, the opportunity to enter new circles could also justify a premium to the DCF based on its existing two circles.

Risks

Our quantitative risk-rating system assigns a default Speculative Risk rating to Spice due its trading history of less than 12 months. We see a Medium Risk rating as more appropriate due to the higher visibility of Indian wireless growth, strong parentage (Telekom Malaysia) and lower financial leverage post-IPO. Spice accumulated significant losses in the past resulting in negative net worth prior to the IPO. It previously defaulted on payments to vendors and debenture holders due to lack of adequate funds and has had qualifications from auditors with respect to its ability to continue operations in absence of access to long-term funds. Going forward, operationally, the risks facing Spice are slightly higher than its more established peers given its smaller scale. Lower-than-expected tenancy in third-party towers and higher capex requirements to increase coverage may depress return parameters. Its equipment sourcing contract with Spice Mobiles Pvt. Ltd, a group company, carries transfer pricing risks as there is lack of clarity on the rationale and cost-plus billing terms. While new circle roll-outs are possible if new spectrum norms are accepted by the DoT (as and when the Defence Department releases spectrum), it will be constrained by management bandwidth and may require a fresh equity infusion. These risk factors could impede the stock from reaching our target price.

Appendix A-1

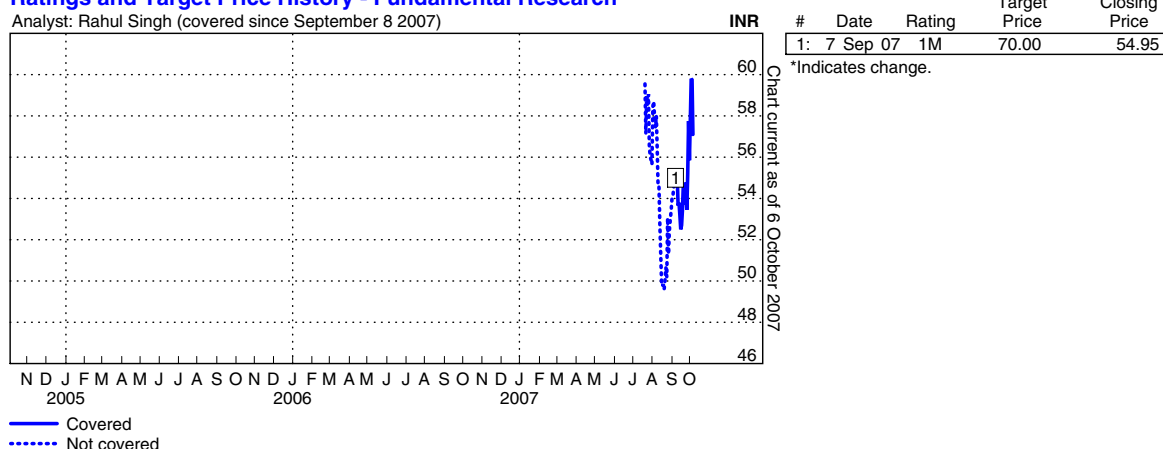
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Analyst: Rahul Singh (covered since September 8 2007)



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