

Industry In-Depth

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Indian Wireless

Towercos – Dealflow to Set Valuation Benchmarks, Bharti Most Leveraged

- Towerco space getting its due** — Judging by the recent interest from investors, realization of the potential value of the towercos is imminent. Recent newspaper reports indicate towercos are in talks to tie-up funds from financial and strategic investors. Potential deal flow with valuation benchmarks would prove positive for the listed wireless stocks.
- First few transactions to provide valuation benchmark** — The first few transactions would provide a benchmark for valuing the nascent towercos segment. This accords greater visibility to monetization of the unlisted towerco value of Bharti & RCOM. Bharti (our top pick) is the most leveraged to valuation upside from towercos. Our estimated explicit value is at Rs145/share. Other players like Idea will benefit indirectly from the imputed “takeout” valuation of their towers.
- Robust fundamentals for towercos** — The fundamentals of tower sharing remain strong in the Indian context given: 1) expected rapid growth in tower count, 2) large number of operators, 3) falling revenue per min, and 4) smaller players’ desire to bridge the coverage gap vis-à-vis the more established peers.
- Bharti to lead from the front** — Bharti’s towerco has a headstart given: 1) the highest tower market share (~40%), 2) unconditional rollout plans (30,000 towers in FY08), and, most importantly, 3) an MoU with Vodafone that imparts greater visibility on average tenancy and operating margins.

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Figure 1. Statistical Abstract

Company	Rating	M Cap US\$M	Share price 6/6/2007	P/E (x)		EV/EBITDA (x)	
				FY08E	FY09E	FY08E	FY09E
Bharti	1L	39,414	837	26.3	21.7	14.8	11.8
RCOM	1M	25,903	511	23.3	17.7	12.7	9.7
Idea	1L	7,936	123	48.9	34.6	16.7	12.6

Source: Citigroup Investment Research estimates

 See Appendix A-1 for Analyst Certification and important disclosures.

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Towerco funding deals to set valuation benchmarks

Telecom infrastructure is seeing tremendous growth with low penetration, high rollout commitments of incumbents and the need to cut capex/opex in the wake of declining revenue per min. While telcos are hiving off their tower infrastructure into separate towercos, some, like GTL infrastructure, Quipo, Xcel Telecom and Essar Telecom are investing in independent towercos. Media reports suggest that these standalone entities plan to spend ~Rs50bn for setting up 18,000 towers during FY08.

Private equity funds have also shown interest in Greenfield towerco's in the recent past:

1. Xcel Telecom has got US\$500m commitment from Texas-based Q Investment for setting up telecom tower infrastructure. It has lined up US\$2bn for acquisitions and project roll-out in the next three years
2. Quipo Infrastructure received funding from IDFC private equity and GIC for funding telecom infrastructure, among other things

Meanwhile, Bharti & RCOM are hiving off their tower infrastructure into separate companies and could sell minority stakes for standalone funding of the resultant towercos. In fact, RCOM's towerco is reported to be in talks with Carlyle, AMT and other private equity investors for funding. We believe that the announcement of a deal would provide better visibility to the latent value of the towercos and help re-rate the underlying listed stocks, especially Bharti and to a lesser extent, RCOM.

Bharti most leveraged to value unlocking from towers

We use a DCF methodology to value Towercos on account of the stable annual cash flows generated. Market multiples such as EV/EBITDA and dividend yield are used more for the purpose of peer comparison. In our note published in Feb 2007, we estimated the option value of Bharti's Towerco at US\$6bn (Rs145/share) using the method. For more details, please refer to <https://www.citigroupgeo.com/pdf/SAP02965.pdf>

While RCOM is actually ahead in the hive-off process (at least the administrative part), we believe that the towerco upside for RCOM will be lesser than Bharti due to: 1) the latter's higher tower count (35,000 vis-à-vis 14,000 for RCOM), 2) RCOM's lower tower add targets for FY08 (20,000 vs. Bharti's 30,000), and 3) Bharti's headstart given the MOU with Vodafone.

Figure 2. Valuation Comparison (EV/EBITDA)

	2008E	2009E
Bharti Airtel (Core business target of Rs800)	14.2	11.3
Bharti's Towerco (DCF value of Rs145/share)	17.5	11.7
American Towers	19.2	17.7
Crown Castle	18.4	16.3
SBA	21.3	19.4
China Communication services*	11.4	9.9
Macquarie Communications*	13.1	12.8
Median of listed peers	18.4	16.3
Bharti Towerco's discount to median on imputed EV/E	(4.9%)	(28.1%)

Source: Citigroup Investment Research estimates

* Not a pure play towerco

The implied EV/EBITDA multiple of Bharti's towerco at a US\$6bn valuation translates into 17.5x for FY08E and 11.7x FY09E. We believe the high EV/EBITDA of towercos in general, and Bharti's towerco in particular, is justified due to:

1. **High operating leverage** – Towerco's typically make EBITDA margins in the region of 50%. This is because any addition of new tenants in addition to the incumbent tenant directly impacts the bottom line with a marginal increase in operating expenses. We expect Bharti's towerco to touch EBITDA margins of ~50% once the average tenancy reaches 2.0.

Figure 3. High Operating Leverage (EBITDA margins)

	2006	2007E	2008E	2009E
American Towers	66.1	67.4	70.3	72.6
Crown Castle	54.2	54.0	55.9	58.7
SBA	44.8	49.8	52.7	55.2
Macquarie*	38.5	39.2	39.6	40.2
Median	49.5	51.9	54.3	56.9

Source: Citigroup Investment Research estimates

2. **High growth** - The number of towers in India are expected to post a CAGR of 38.5% between FY07E and FY09E on the back of a rapid increase in coverage. The introduction of 3G will also support the growth since it requires a greater density of coverage.

Figure 4. Number of Towers

	FY06	FY07E	FY08E	FY09E
No. of towers	55,055	96,115	145,970	184,360
<i>Growth (%)</i>	<i>60.1</i>	<i>74.6</i>	<i>51.9</i>	<i>26.3</i>

Source: Companies, Citigroup Investment Research estimates

3. **Tower sharing a necessity** – We believe that tower sharing is a necessity in the Indian context. With seven operators, increasing rural rollout and declining EBITDA/min, operators are always on the lookout to cut costs in order to maintain the presently healthy paybacks of 2-3 years. Once 2-3 operators start sharing and lower their costs, the rest of the industry cannot stay away for too long, thus making it a virtuous cycle. For the smaller players, shared tower infrastructure will also help them catch up faster with their more established peers in terms of coverage.
4. **Bharti's towerco enjoys a headstart** – This is a result of its high tower share, unconditional rollout and most importantly, the MoU with Vodafone, which increases its average tenancy and places it in a position where it would be able to offer better rates to the prospective tenants as compared to other towercos.

Bharti Airtel (BRTI.BO - Rs833.30; 1L)

Valuation

Our 12-month forward target price of Rs960 is based on core DCF of Rs800 and a towerco option value of Rs158. The core DCF (as on March-08) is based on a WACC of 10.8%, a terminal growth rate of 4% and beta of 0.9 (implying a terminal EV/EBITDA multiple of 8.5x). We prefer DCF as our primary valuation

methodology because the wireless market will likely continue to post robust growth requiring upfront capex, but should generate significant free cash beyond 2009-10. Our target price (net of towerco value) represents a FY09E P/E of 20.8x, P/CEPS of 12.9x and EV/EBITDA of 11.3x. The imputed target P/E (net of towerco) of 25.0x FY08E is at 25% premium to the broad market P/E (20.0x FY08E at the higher end of our Sensex target of 16,000). This, we believe, is justified by above-average earnings growth, improved earnings visibility and relative insulation from macro risks.

Risks

Our quantitative risk-rating system, which tracks 260-day share price volatility, rates Bharti as Low Risk. We are comfortable attributing a Low Risk rating for the following reasons: (1) Bharti has a track record of profitability and execution; (2) the company's capex plans are fully funded, and (3) the strategic shareholding of SingTel leaves us comfortable with execution issues and initiatives. The risks that could prevent the stock from reaching our target price include competition-led tariff pressures, un-remunerative capex, overall market downside, and slower-than-expected execution of the tower sharing initiative.

Reliance Communications (RLCM.BO - Rs505.05; 1M)

Valuation

In valuing Indian wireless plays, we use DCF as our primary methodology given the back-ended nature of profits and cash flow. In the case of RCOM, however, we use EV/EBITDA in the absence of a detailed balance sheet, which is awaiting reorganization. Our 12-month target price of Rs510 is based on 9.6x FY09E EV/EBITDA, at a 15% discount to Bharti's target multiple (ex- towerco) to reflect the uncertainty regarding the timing of GSM rollout and the associated challenges. We expect RCOM's valuation multiples to broadly track Bharti's due to the liquidity overflow from the latter, notwithstanding the risk of technology transition. The potential IPO of FLAG would also act as a likely trigger to the stock over the next 3-6 months. Meanwhile, higher-than-average earnings growth (CAGR of 39.0% over FY07-09E) and low sensitivity of wireless demand to interest rates will continue to support premium valuations for the sector.

Risks

Our quantitative risk-rating system, which tracks 260-day share price volatility, assigns a High Risk rating to RCOM, but we believe a Medium Risk rating is more appropriate. RCOM has been de-merged from Reliance Industries, and its shareholding at the time of listing mirrored the holding of RIL. The stock is therefore unlikely to have risk factors that are typical of newly listed companies, that have more limited management and operating track records. Besides, growth in the telecom sector accords visibility to RCOM's prospects – characteristics that are similar to those of its peers. However, we believe its evolving financial history and risks pertaining to GSM overlay, warrant a risk rating higher than we assign to Bharti (Low Risk). Downside risks to our target price include smaller-than-expected market share, lower-than-anticipated operating leverage (especially for FY07), cost-overruns in GSM overlay, regulatory and competition risks, un-remunerative capex, delays in the ongoing re-organization and more telecom-related paper entering the market.

IDEA Cellular (IDEA.BO - Rs126.10; 1L)

Valuation

We have set our 12-month target price at Rs112 based on Mar-08E DCF, which we think is an appropriate method due to the back-ended nature of free cash flows given the new circle roll-outs. Our DCF assumes a WACC of 10.8% 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 FY07-16E with a terminal year EBITDA margin at 37.1% (~200bps below Bharti) and capex/sales of ~10% (in line with Bharti). The target price implies an EV/EBITDA of 11.6x, a slight premium to Bharti's target multiples (for the ex-towerco portion of Rs800), which we believe is supported by: (1) higher EBITDA growth rates for Idea, (2) liquidity overflow from Bharti's foreign limit constraints, and (3) M&A possibilities in the long run, given Idea's good fit for the potential suitors.

Risks

Our quantitative risk rating system assigns a default Speculative Risk rating to Idea, due to its trading history of less than 12 months. We believe, however, that a Low Risk rating is more appropriate due to the higher visibility of Indian wireless growth, Idea's reasonably competitive position, strong parentage and the reduction of financial leverage post-IPO. Operationally, the risks facing Idea are slightly higher than its more established peers on account of the roll out in new circles. Project cost over-runs, delays in spectrum allocation and hence commercial launches could affect the value accretion opportunity in the new circles. Idea will also face competition from the established players in the new circles and market share gains may be lower than expected. Idea will incur higher capex requirements in the new circles due to the coverage compulsions, which may depress return parameters in the initial years. Any rollout plans beyond 13 circles may also require a fresh equity infusion. These risk factors could impede the stock from reaching our target price.

Appendix A-1

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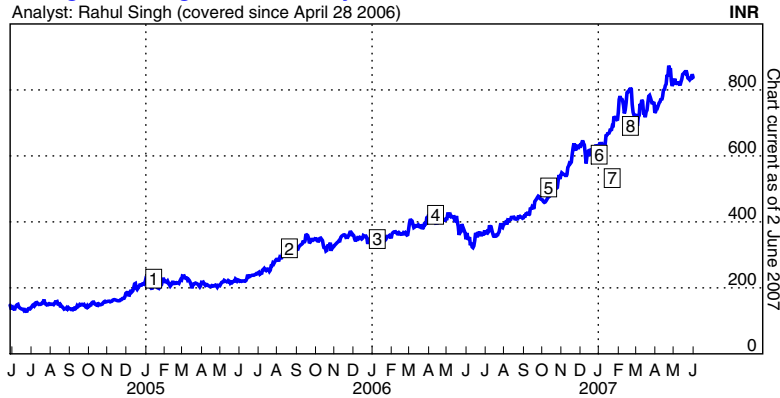
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Ratings and Target Price History - Fundamental Research

Analyst: Rahul Singh (covered since April 28 2006)



#	Date	Rating	Target Price	Closing Price
1:	14 Jan 05	*1M	*260.00	210.30
2:	22 Aug 05	1M	*400.00	306.10
3:	10 Jan 06	1M	*450.00	339.25
4:	13 Apr 06	1M	*500.00	395.95
5:	12 Oct 06	*1L	*600.00	475.65
6:	2 Jan 07	1L	*750.00	633.00
7:	23 Jan 07	1L	*800.00	689.15
8:	21 Feb 07	1L	*960.00	806.30

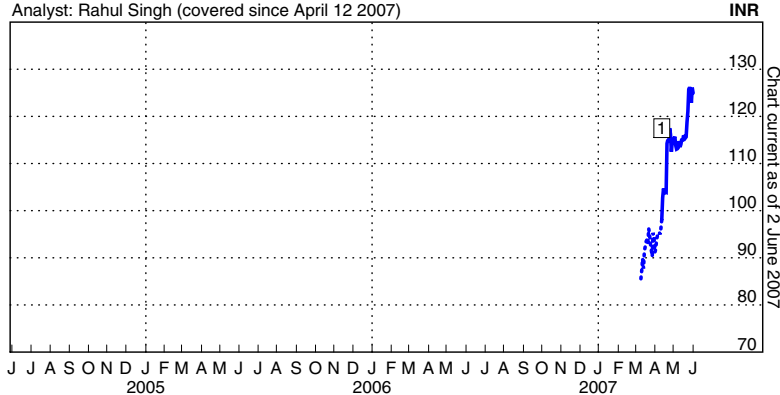
*Indicates change.

— Covered
 Not covered

IDEA Cellular (IDEA.BO)

Ratings and Target Price History - Fundamental Research

Analyst: Rahul Singh (covered since April 12 2007)



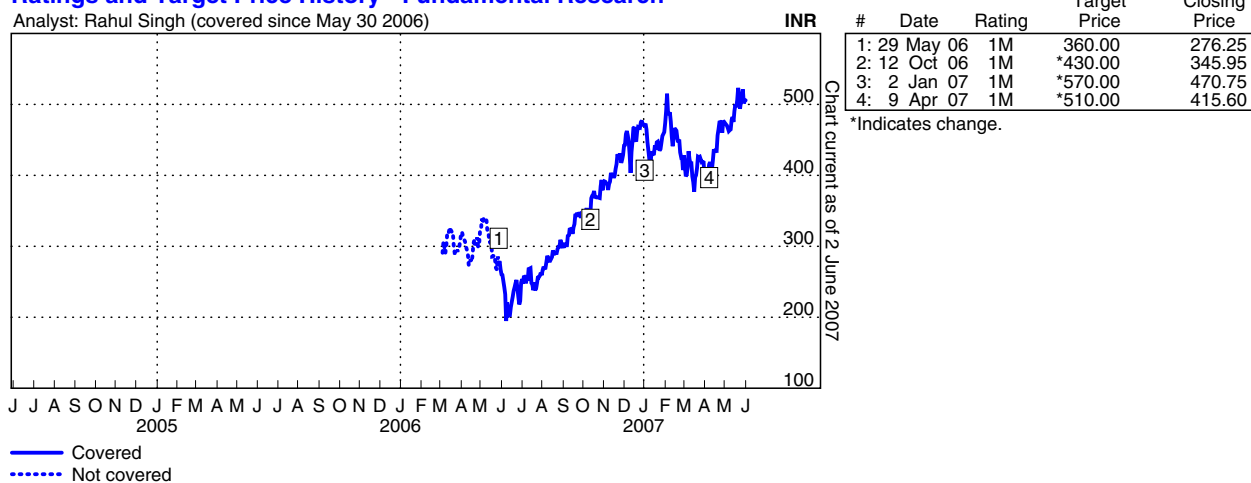
#	Date	Rating	Target Price	Closing Price
1:	12 Apr 07	1L	112.00	98.15

*Indicates change.

— Covered
 Not covered

Reliance Communications (RLCM.BO) Ratings and Target Price History - Fundamental Research

Analyst: Rahul Singh (covered since May 30 2006)



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