

**Telecoms, Media & Technology**  
**Diversified Telecoms**  
 Equity – India

## Underweight (V)

**Target price (INR)** 227  
**Share price (INR)** 300  
**Potential total return (%)** -24.3

Performance	1M	3M	12M
Absolute (%)	2.7	2.5	-10.4
Relative <sup>^</sup> (%)	-4.5	-9.4	-33.5

Index<sup>^</sup> BOMBAY SE IDX

RIC RLCM.NS  
 Bloomberg RCOM IN

Market cap (USDm) 13,022  
 Market cap (INRm) 618,795

Free float (%) 30

Note: (V) = volatile (please see disclosure appendix)

**7 October 2009**

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# Reliance Communications (RCOM)

Downgrade to UW(V): RCOM gets defensive

- ▶ **RCOM has cut its outgoing call tariffs by c35%, a move driven by recent sector-wide tariff cuts**
- ▶ **We do not expect the price cut to be offset by elasticity and subscriber growth: we reduce FY11e EPS by c5%**
- ▶ **Downgrade to UW(V) from N(V); cut TP to INR227 (INR280)**

**Event:** RCOM's move to cut tariffs by c35% is significantly negative; we view it as an acknowledgement of the risk of CDMA market share loss. We believe the move is not in isolation, but rather a response to meet internal growth targets and reflects rapidly deteriorating industry pricing dynamics. The read-across for Bharti Airtel and Vodafone is negative, in our view, as they may have to respond with cuts in roaming rates to retain their high-end subscriber and revenue market shares. We think the tariff war will continue across the sector, and expect headline rates to stabilise at c10% lower (ie, local call tariff: INR0.4; STD: INR0.5) over the next six months.

**Impact:** After assuming a part-offset from usage elasticity and a higher rate of subscriber additions, we have cut our FY11e EPS estimates by c5%. Our numbers do not capture the shift to a per-second billing regime, which would imply c12% exposure to FY11e revenues and 20% exposure to FY11e earnings. Given its new entrant status in the GSM space and structural constraints with spectrum in the 1800 MHz band, we believe RCOM had little choice after the recent price cuts by new entrants and market share gains by Tata-DoCoMo. Besides, upsidings are limited for RCOM, as these rates are likely to be matched by the new entrants soon.

**RCOM needs higher capex:** We maintain that RCOM's ability to capture subscriber growth from rural and semi-urban centres will be constrained by its low tower base (currently 50,000). Thus, we do not believe RCOM is best placed to cut capex and generate growth. We do not think RCOM is well placed to weather the increasing competitive intensity, given its stretched balance sheet, thin tower base and sub-optimal 1800 MHz spectrum in 15 new GSM markets.

**Downgrade to UW(V):** We cut our target price to INR227, which implies 11.3x FY11e PE (c50% discount to Sensex) and 6.7x EV/EBITDA. We downgrade our rating, given the pricing pressure and structural limitations to weather the competitive intensity.

### RCOM: key financials

	2009	2010e	2011e	2012e
Revenue (INRm)	229,411	254,451	286,134	320,687
EBITDA margin	40.5%	40.3%	38.7%	39.6%
EPS (INR)	28.8	26.1	20.0	21.7

Source: Company data, HSBC estimates

## Impact of tariff cuts

We view RCOM's move as revenue-destructive for both the company and the sector. As per our analysis, the move to the new tariff plan implies that RCOM's rates on outgoing minutes decline by c35% and ARPU by c25% (assuming no usage buoyancy). Our analysis suggests, to compensate for the revenue loss, RCOM would incrementally require c7m high-end subscribers, which in our view is a daunting task, as its GSM operations are in the 1800 MHz band. While the lower rates may imply a higher pace of subscriber additions and improved elasticity, we do not believe this is sufficient to compensate for the revenue loss. Our cautious view is driven by RCOM's structural constraints of operating in the 1800 MHz spectrum and inadequate capex, despite the low number of towers. We believe RCOM will find it difficult to sustain its subscriber growth with the current 50,000 towers.

### Analysis of RCOM's recent tariff cuts

Particulars	INR, unless stated otherwise
ARPU	210
(Value added services ARPU) estimated by HSBC	6%
Voice ARPU	197.4
Minutes of usage (minutes)	365
Revenue per minute	0.54
Outgoing minutes as per TRAI data	47%
Incoming minutes	53%
Termination charges	0.2
Mobile termination revenue per subscriber	38.8
Outgoing revenue per subscriber	158.6
Outgoing realised rates	0.93
New implied rate assuming granularity	0.60
Downside to outgoing realised rate	-35%

Source: HSBC estimates

## Our key estimate changes

### RCOM: our estimate changes

(INRm)	FY10e			FY11e		
	New	Old	Change	New	Old	Change
Sales	254,451	262,141	-2.9%	286,134	297,397	-3.8%
EBITDA	102,556	105,480	-2.8%	110,811	119,385	-7.2%
Net Income	53,457	56,506	-5.4%	41,121	43,328	-5.1%
EPS (INR)	26.1	27.5	-5.4%	20.0	21.1	-5.1%

Source: HSBC estimates

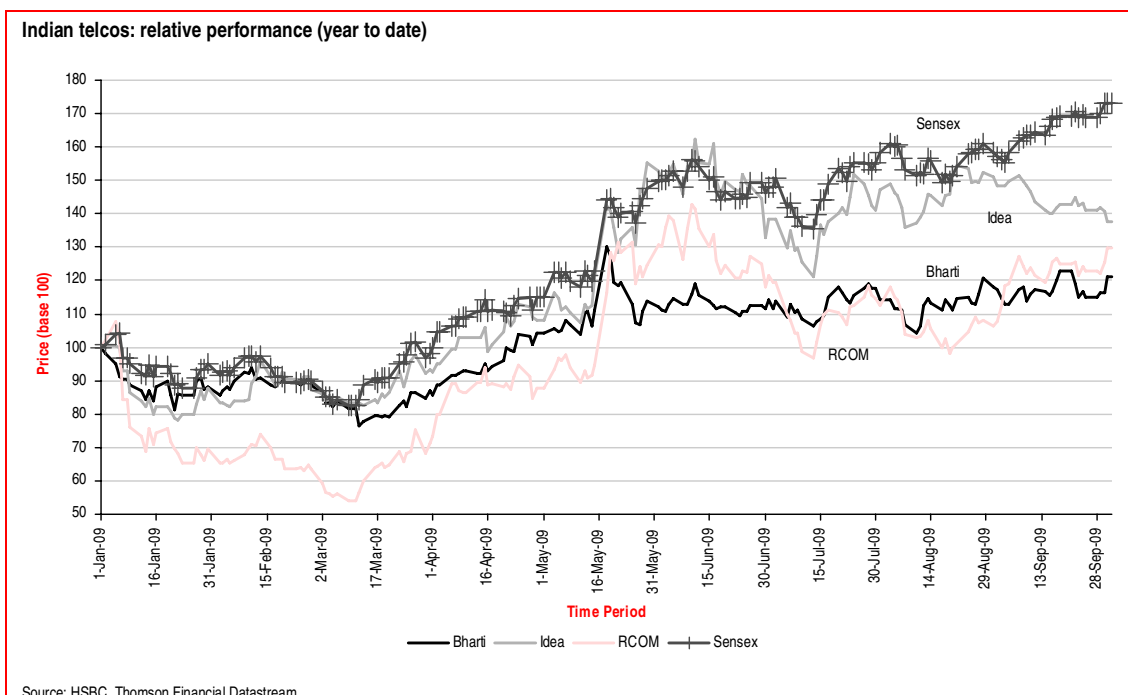
## Valuation and risks

### Core business

We value RCOM at INR227, based on a blended approach (we use both PE and DCF). For our DCF valuation, we assume a cost of equity of 12% (our strategy team has computed a baseline COE of 10.5% for India, and we assume a rate 100bp higher, given RCOM's stretched balance sheet). Given the improvement in market liquidity, we take a cost of debt of 10%. Our target debt-to-equity ratio is 15%; our assessment of weighted average cost of capital (WACC) is 11.5 % and the terminal growth rate is c3%. The fair value from our DCF is INR214/share. For our multiples-based approach, our PE is 12x (lower than our earlier assumption of 13x, given the cautious outlook on pricing and earnings decline). Our target implies FY11e PE of 11.3x (c50% discount to the current Sensex multiple) and EV/EBITDA of 6.7x and implies a c32% discount to our target price for Bharti compared with an historical average discount of c39%. The fair value from our PE valuation is INR240/share. We assign equal weight to our approaches, deriving a target price of INR227/share.

Our revised target price for RCOM implies a c24% potential negative return, which is below the 0.5-20.5% Neutral band for volatile Indian stocks under our research model. We therefore downgrade our rating to Underweight (V) from Neutral (V). Our downgrade is driven by the rising competitive intensity, declining tariffs and lower capex deployments (which we think will result in lower longer-term market share). Our recent downgrade of Bharti to Neutral (V) from Overweight (V) (published 1 October) and downgrade of RCOM to Underweight (V) is a reflection of deteriorating industry dynamics and our cautious view on the sector.

**Risks:** We recognise RCOM could benefit from 3G services, given its CDMA capabilities and fibre backhaul, but believe it is still too early to give much credit to this opportunity, and view this an upside risk. Data cards on the CDMA platform may allow RCOM to have higher-than-estimated ARPU and we view higher-than-estimated elasticity as a further upside risk.

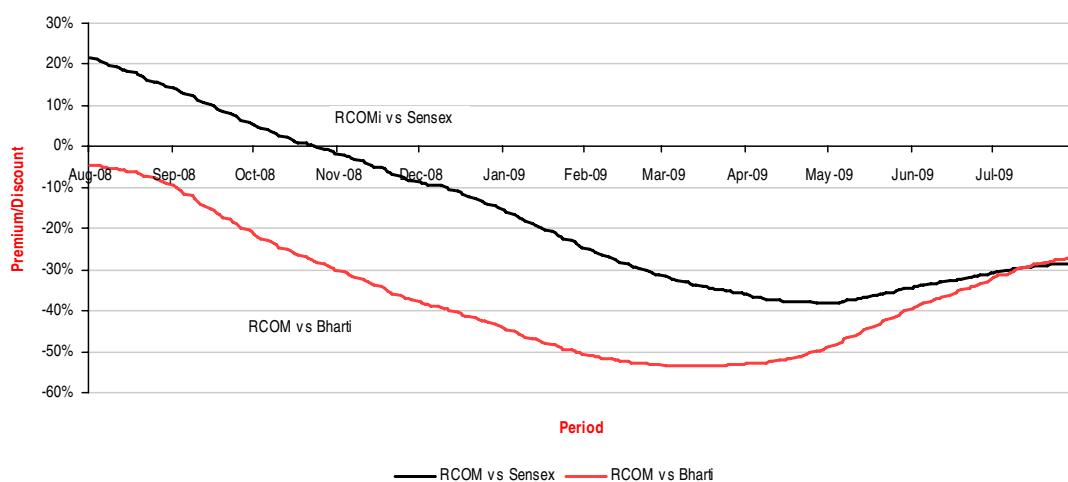


**Peer group comparison based on consensus estimates**

Company	Ticker	Stock price (INR)	HSBC rating	TP (INR)	Pot return (%)	Consensus PE (x) FY10e	Consensus PE (x) FY11e	Consensus EV/EBITDA (x) FY10e	Consensus EV/EBITDA (x) FY11e
Bharti	BHARTI IN	400	Neutral (V)	448.0	12%	15.2x	13.7x	9.1x	8.0x
RCOM	RCOM IN	300	Underweight (V)	227.0	-24%	12.5x	11.5x	8.5x	7.1x
Idea Cellular	IDEA IN	70	Neutral (V)	85.0	21%	20.1x	17.6x	7.0x	5.8x

Source: HSBC estimates, Thomson Financial Datastream

**RCOM's one-year forward PE vs Sensex and Bharti**



Source: HSBC, Thomson Financial Datastream

**RCOM's one-year forward PE band**



Source: HSBC, Thomson Financial Datastream

## Financials & valuation

### Financial statements

Year to	03/2009a	03/2010e	03/2011e	03/2012e
<b>Profit &amp; loss summary (INRm)</b>				
Revenue	229,411	254,451	286,134	320,687
EBITDA	92,875	102,556	110,811	127,106
Depreciation & amortisation	-39,313	-48,409	-56,180	-60,796
Operating profit/EBIT	53,562	54,147	54,631	66,310
Net interest	7,867	9,608	-4,586	-10,084
PBT	61,354	63,644	50,045	56,226
HSBC PBT	61,429	63,755	50,045	56,226
Taxation	123	-8,850	-8,066	-10,597
Net profit	59,078	53,457	41,121	44,587
HSBC net profit	59,153	53,568	41,121	44,587

### Cash flow summary (INRm)

Cash flow from operations	53,691	88,073	78,240	101,694
Capex	-190,000	-72,075	-145,498	-80,022
Cash flow from investment	-193,676	-72,075	-145,498	-80,022
Dividends	0	0	0	0
Change in net debt	142,554	-78,798	75,884	-7,552
FCF equity	-104,659	34,629	-75,884	7,552

### Balance sheet summary (INRm)

Intangible fixed assets	52,215	52,215	52,215	52,215
Tangible fixed assets	727,053	688,933	778,252	797,478
Current assets	239,945	219,067	211,319	220,889
Cash & others	109,629	65,000	65,000	65,000
Total assets	1,022,070	961,534	1,043,105	1,071,901
Operating liabilities	159,718	232,274	195,982	186,701
Gross debt	391,622	268,195	344,079	336,528
Net debt	281,993	203,195	279,079	271,528
Shareholders funds	422,803	414,256	455,377	499,964
Invested capital	749,866	662,941	780,805	818,882

### Ratio, growth and per share analysis

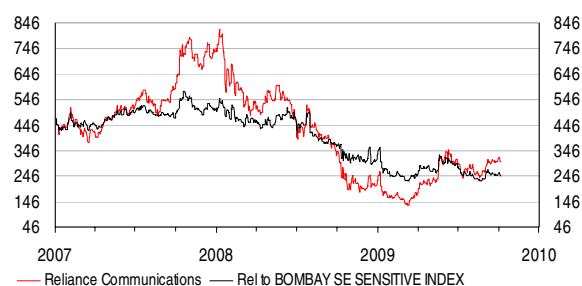
Year to	03/2009a	03/2010e	03/2011e	03/2012e
<b>Y-o-y % change</b>				
Revenue	20.3	10.9	12.5	12.1
EBITDA	13.3	10.4	8.0	14.7
Operating profit	-0.7	1.1	0.9	21.4
PBT	-13.3	3.7	-21.4	12.4
HSBC EPS	42.9	-9.4	-23.2	8.4
<b>Ratios (%)</b>				
Revenue/IC (x)	0.4	0.4	0.4	0.4
ROIC	8.6	6.6	7.0	7.7
ROE	16.6	12.8	9.5	9.3
ROA	6.0	4.7	4.6	5.2
EBITDA margin	40.5	40.3	38.7	39.6
Operating profit margin	23.3	21.3	19.1	20.7
EBITDA/net interest (x)			24.2	12.6
Net debt/equity	65.7	48.2	60.2	53.3
Net debt/EBITDA (x)	3.0	2.0	2.5	2.1
CF from operations/net debt	19.0	43.3	28.0	37.5
<b>Per share data (INR)</b>				
EPS reported (fully diluted)	28.79	26.05	20.04	21.73
HSBC EPS (fully diluted)	28.82	26.10	20.04	21.73
DPS	0.00	0.00	0.00	0.00
Book value	206.02	201.86	221.90	243.62

### Valuation data

Year to	03/2009a	03/2010e	03/2011e	03/2012e
EV/sales	3.9	3.2	3.1	2.8
EV/EBITDA	9.7	8.0	8.1	7.0
EV/IC	1.2	1.2	1.1	1.1
PE*	10.4	11.5	15.0	13.8
P/Book value	1.5	1.5	1.4	1.2
FCF yield (%)	-17.0	5.6	-12.3	1.2
Dividend yield (%)	0.0	0.0	0.0	0.0

Note: \* = Based on HSBC EPS (fully diluted)

### Price relative



Note: price at close of 05 Oct 2009

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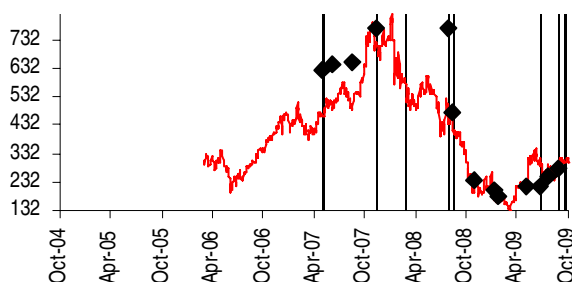
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<b>Overweight (Buy)</b>	36%	(33% of these provided with Investment Banking Services)
<b>Neutral (Hold)</b>	41%	(28% of these provided with Investment Banking Services)
<b>Underweight (Sell)</b>	23%	(30% of these provided with Investment Banking Services)

## Share price and rating changes for long-term investment opportunities

Reliance Communications (RLCM.NS) Share Price performance INR Vs HSBC rating history



Source: HSBC

### Recommendation & price target history

From	To	Date
N/A	Overweight (V)	03 May 2007
Overweight (V)	Neutral	15 November 2007
Neutral	Restricted	22 February 2008
Restricted	Neutral	04 August 2008
Neutral	Neutral (V)	15 August 2008
Neutral (V)	Underweight (V)	29 June 2009
Underweight (V)	Neutral (V)	01 September 2009
Target Price	Value	Date
Price 1	624.00	03 May 2007
Price 2	644.00	12 June 2007
Price 3	651.00	23 August 2007
Price 4	775.00	15 November 2007
Price 5	Restricted	22 February 2008
Price 6	775.00	04 August 2008
Price 7	475.00	15 August 2008
Price 8	235.00	05 November 2008
Price 9	202.00	13 January 2009
Price 10	180.00	27 January 2009
Price 11	218.00	05 May 2009
Price 12	214.00	29 June 2009
Price 13	250.00	23 July 2009
Price 14	280.00	01 September 2009

Source: HSBC



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RELIANCE COMMUNICATIONS	RLCM.NS	299.80	06-Oct-2009	1, 2, 5

Source: HSBC

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