# Mahanagar Telephone Nigam

MTNL IN

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India
Telecommunications

Initiation
21 November 2008

**SO WHAT? THE BNP PARIBAS ANGLE** — **INDUSTRY OUTLOOK: ↑**

- Our TP is 50% below street
- Our FY09 EPS is 36.4% below Street as we are modelling EBITDA margin of 9.7% versus Street at 14.2%
- We estimate cash/share to decline to INR39 from INR61 on payment of revised salaries and 3G spectrum fees

**Net Profit 09** ......... **INR2.8b**

**Diff from Consensus** **(36.4%)**
Consensus (mean) ..........INR4.4b
Consensus (momentum) .......... ↓

**Target Price** ....... **INR55.00**

**Diff from Consensus** **(49.7%)**
Consensus (median)... INR109.38
Consensus (momentum) .......... ↓

**Current Price** ....... **INR72.10**
Upside/(Downside)...........(23.7%)

**REDUCE**

**Recs in the Market**
Positive.......................................4
Neutral........................................4
Negative ....................................6
Consensus (momentum) ......... ↓

Sources: Thomson One Analytics; Bloomberg; BNP Paribas estimates

- **Initiate with REDUCE and TP of INR55 (cash per share of INR39 and core business at INR16 or 2.5x FY09 EBITDA).**
- **Increased competition, market saturation and higher staff costs resulting in lower profitability and ROE for MTNL.**
- **Valuations converging towards cash/share; cash/share will decline due to spectrum costs and salary increments.**

## Cash levels set to decline – REDUCE

### Initiating coverage with REDUCE rating and a TP of INR55

We initiate coverage on Mahanagar Telephone Nigam (MTNL), a government-owned telecom operator, with a REDUCE rating and TP of INR55 based on a cash per share of INR39 and a core business valuation of INR16 at 2.5x FY09 EBITDA. Historically MTNL traded close to its book value but the valuation is now converging towards its cash per share as its ROE has declined to 3.3%, well below its cost of capital, and one-fourth of its book value is amount recoverable from Department of Telecom, which is unconfirmed and outstanding for several years.

### Cash per share will dip to INR39 from INR 61

Our proprietary cash analysis shows cash per share declining to INR39 from INR61 after paying for 3G spectrum and salary increments. We are conservatively modeling 3G spectrum payments at 2x reserve price in two most sought after circles, salary arrears at 25% increment on 1 January 2007 salary base and an income tax refund of INR 6b.

### Wire-line revenue -- the lifeline of MTNL -- on the decline

We believe MTNL faces significant revenue risk as its wire-line segment, which contributes 70% of its revenue, will continue to decline due to subscriber loss and reduction in tariffs. The wire-line penetration in the two cities (Mumbai and Delhi) has reached a plateau and increasing competition is cannibalizing into MTNL's market share. MTNL is also losing market share in the Public Call Office (PCO) segment. The wire-line tariffs are under constant pressure from the declining wireless tariffs.

### Unable to capitalize on broadband and mobile services

Our channel checks reveal that there is a delay of up to six months to get MTNL broadband connection due to which it is unable to capitalize on the broadband opportunity. MTNL's areas of operation have the highest wireless penetration and are close to saturation. We believe that MTNL will find it extremely difficult to protect its wireless market share in competition with more efficient private operators who are reducing tariffs leveraging scale economies, coupled with superior customer service.

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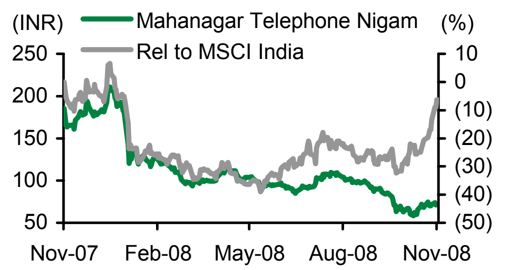
**Earnings Estimates And Valuation Ratios**

| YE Mar (INR m) | 2008 | 2009E | 2010E | 2011E |
|---|---|---|---|---|
| Revenue | 47,672 | 45,277 | 43,367 | 43,743 |
| Reported net profit | 3,863 | 2,773 | (1,156) | (904) |
| Recurring net profit | 3,863 | 2,773 | (1,156) | (904) |
| Recurring EPS (INR) | 6.13 | 4.40 | (1.83) | (1.43) |
| Rec EPS growth (%) | (15.8) | (28.2) | neg | neg |
| Recurring P/E (x) | 11.8 | 16.4 | neg | neg |
| Dividend yield (%) | 5.5 | 5.5 | 5.5 | 5.5 |
| EV/EBITDA (x) | 2.1 | 1.9 | neg | neg |
| Price/book (x) | 0.4 | 0.4 | 0.4 | 0.4 |
| ROE (%) | 3.3 | 2.3 | (1.0) | (0.8) |
| Net debt/equity (%) | (32.1) | (30.4) | (30.3) | (29.3) |

Sources: Mahanagar Telephone Nigam; BNP Paribas estimates

**Share Price Daily vs MSCI**




| | |
|---|---|
| Next results/event | January 2009 |
| Market cap (USD m) | 913 |
| 12m avg daily turnover (USD m) | 7.3 |
| Free float (%) | 20 |
| Major shareholder | Government of India (56%) |
| 12m high/low (INR) | 211.00/58.55 |
| ADR (USD) | 3.00 |
| Avg daily turnover (USD m) | 0.1 |
| Discount/premium (%) | 2.0 |
| Disc/premium vs 52-wk avg (%) | (45.0) |

Source: Datastream

# Contents



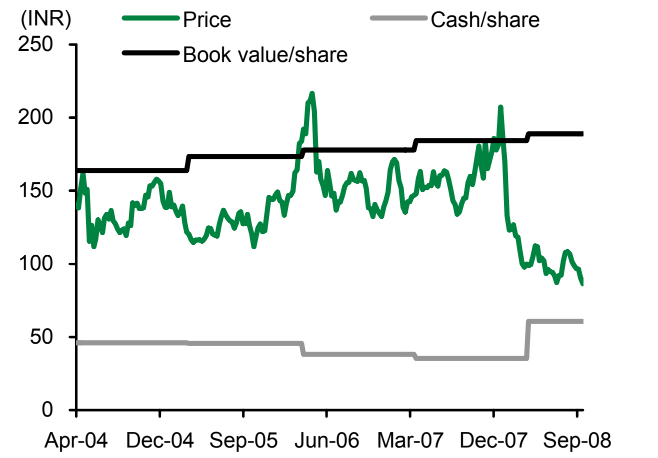
*Please see India Research Team list on page 20.*

VALUATIONS: CASH TO DIP

# Dip in cash level will reduce valuations

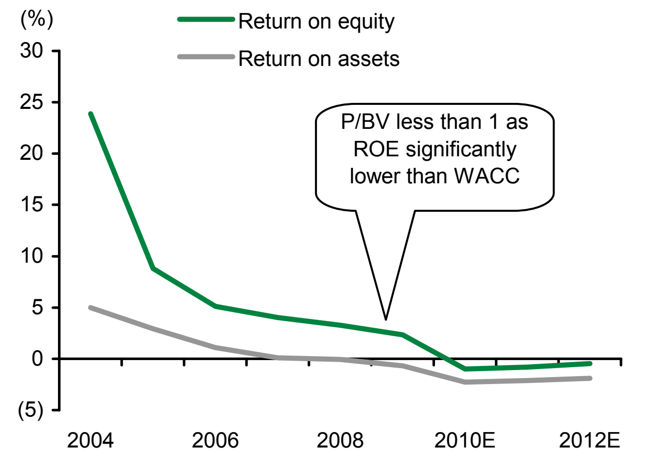
**We value MTNL at INR55 based on adjusted cash per share of INR39 and a core business valuation of INR16 at 2.5x FY09 EBITDA. MTNL has historically traded close to its book value. However, the valuations are now converging towards its cash per share as its ROE has declined to 3.3%, well below the cost of capital. We expect the cash per share to decline from INR61 to INR39 with increased payout for 3G spectrum and higher employee costs putting further pressure on valuations. Our TP translates into a dividend yield of 7.3% based on a historical dividend payout of INR4 per year.**

**Exhibit 1: Price Converging From Book Value To Cash/Share**




Sources: Mahanagar Telephone Nigam; Datastream; BNP Paribas

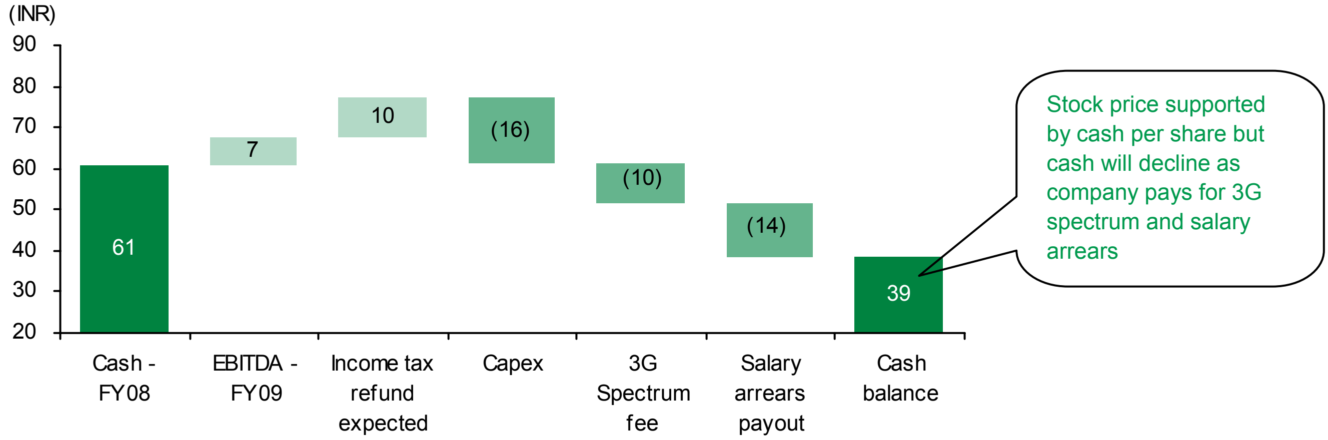
**Exhibit 2: Price Below Book As ROE Below WACC**




Sources: Mahanagar Telephone Nigam; BNP Paribas estimates

MTNL has historically traded close to its book value per share. The stock valuation is now converging with the cash per share and is trading at 0.4x its book value as MTNL's ROE at 2-4% has dropped significantly below its cost of capital. We expect ROE to be depressed in the coming quarters due to lower profitability.

**Exhibit 3: Estimated Change In Cash Balance Over The Next One Year**




Source: BNP Paribas estimates

**Exhibit 4: Valuation: Adjusted Cash + Operating Business (Ex Cash)**

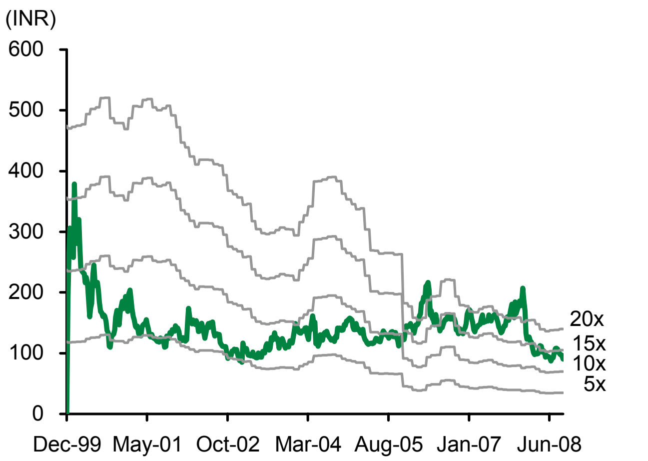
| Details | Cash (INR m) | Per share (INR) | Methodology |
|---|---|---|---|
| Cash balance – FY08 | 33,823 | 54 | FY08 balance |
| Investments – FY08 | 4,517 | 7 | Taken at full value |
| **Total cash** | **38,340** | **61** | |
| EBITDA | 4,398 | 7 | FY09 EBITDA estimate |
| Capex | (9,961) | (16) | FY09E Capex estimate |
| 3G Spectrum fees | (6,400) | (10) | Assumed at 2x the reserve price of INR1.6b for both Mumbai and Delhi |
| Salary arrears | (8,030) | (13) | Assumed 25% hike; Effect of lump sum salary arrears amount payable WEF 1 January 2007 |
| Income tax refunds expected | 6,000 | 10 | |
| **Adjustments** | **(13,993)** | **(22)** | |
| **Adjusted cash balance** | **24,347** | **39** | |
| Core business | | 16 | Valued at 2.5x FY09 EBITDA. We expect the EBITDA to turn negative in FY10 on salary revision as revenue would continue to decline |
| **Target price** | | **55** | |

Sources: Mahanagar Telephone Nigam; BNP Paribas estimates

## Cash per share set to decline

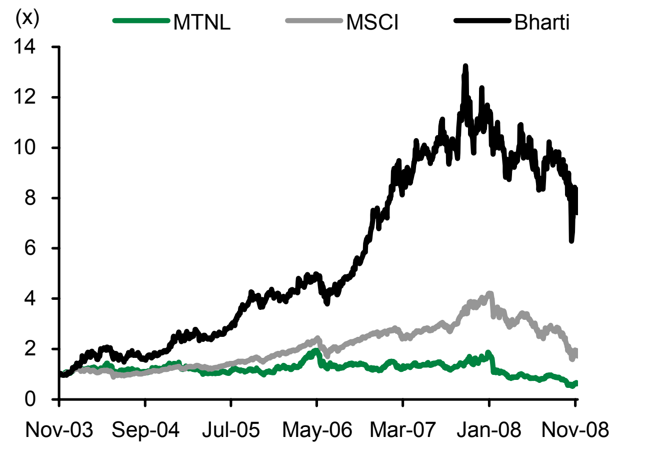
MTNL's cash per share declined consistently until FY08 (increase in cash in FY08 was due to a non-recurring income tax refund). We believe that the cash per share will dip further to INR39 from INR61 due to the impending revision in employee salaries based on the government's recommendations and 3G spectrum payment for two of the most sought after telecom circles in India.

**Exhibit 5: Still Not Trading At Trough Earnings Multiple**




Sources: Mahanagar Telephone Nigam; Datastream; BNP Paribas

**Exhibit 6: Price Performance: Tough Times Ahead; Underperformance Will Continue**




Source: Datastream

**Trading above the trough P/E multiple:** On a P/E basis, the stock is trading higher than its trough multiple of 5x witnessed in 2000-02. We believe that the profitability over the next two years will be significantly affected due to salary increases and 3G investments making the stock look more expensive on a P/E multiple.

**MTNL has underperformed MSCI and Bharti:** MTNL has underperformed MSCI and the private Indian telecom operators and we do not expect any reversal in this trend. MTNL has been a laggard, down 42% over the past five years compared to MSCI India and Bharti, which went up 82% and 663%, respectively over the same period. The decline occurred even though MTNL was part of the strong growth seen in the wireless and internet business during this period. We expect the future to be even more challenging for MTNL as wire-line revenue would continue to be under pressure and the best of the wireless growth behind us.

**MTNL stock has underperformed MSCI India and Bharti significantly. We expect the trend to continue.**

PROFITABILITY: SET TO DETERIORATE

# Lower profits from falling revenue and higher staff costs

**MTNL's revenue has declined at a CAGR of 7% over FY04-08. We expect the revenue decline will continue due to increasing competition, market saturation and falling tariffs. We expect the expenditure will rise with the salary increases based on the Second Pay Commission's recommendations and 3G investments. Combination of these factors would lead to a significant erosion of profitability.**

We believe MTNL's profitability is set to deteriorate in the coming quarters.

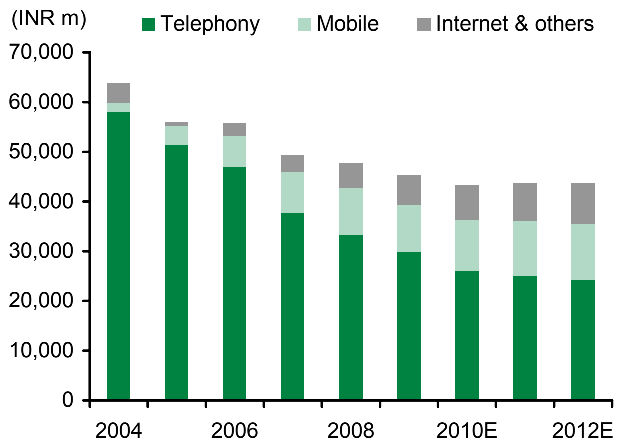
MTNL revenue has been declining and we expect the trend to continue

- **Revenue will decline:** Wire-line revenue will decline due to a constrained market and reducing tariffs; wireless revenue would fall due to intensifying competition and saturated wireless penetration; and broadband segment growth would slow due to capacity constraints and inability to provide appropriate customer service experience.
- **Costs will rise:** MTNL's operating expenses will increase as the employee cost, which accounts for ~35% of total revenue, is set for an increase on salary revisions. We are not factoring in any costs or revenue pertaining to 3G services. However, the profitability will further deteriorate if we incorporate 3G as initial revenue will be significantly lower than the operating cost of a 3G network.

Over the last 3 years net income has been equal to other income

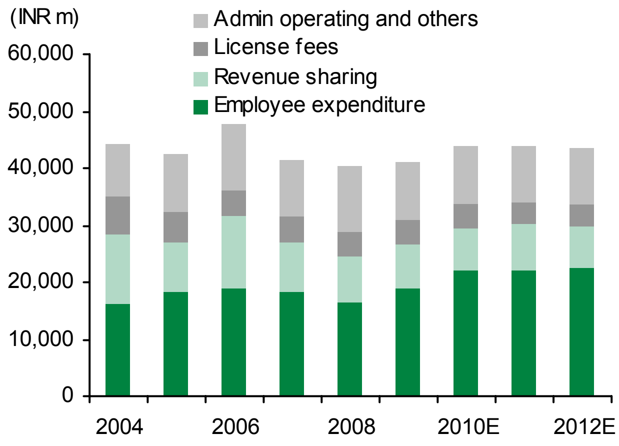
- **Net income being driven by other income:** We observe that over FY07 and FY08, other Income has driven MTNL's net income. Other income was INR6.7b or 99% of net income in FY07 and INR6.1b or 107% of net income in FY08. Other income included interest on income tax refund to the extent of INR3.2b in FY07 and INR1.8b in FY08.

Exhibit 7: Revenue Would Fall Due To Increased Competition



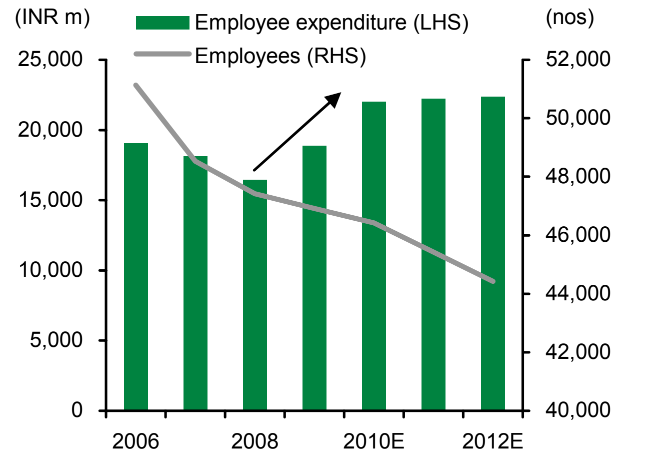

Sources: Mahanagar Telephone Nigam; BNP Paribas estimates

Exhibit 8: Total Cost Will Rise Led By Employee Costs



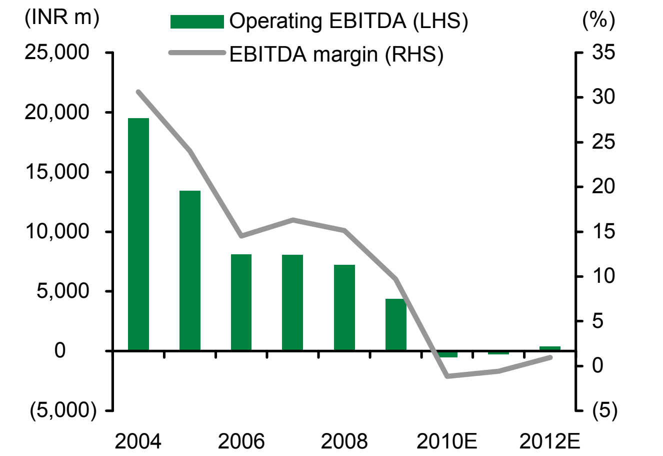

Sources: Mahanagar Telephone Nigam; BNP Paribas estimates

**Exhibit 9: Staff Cost Set To Rise**



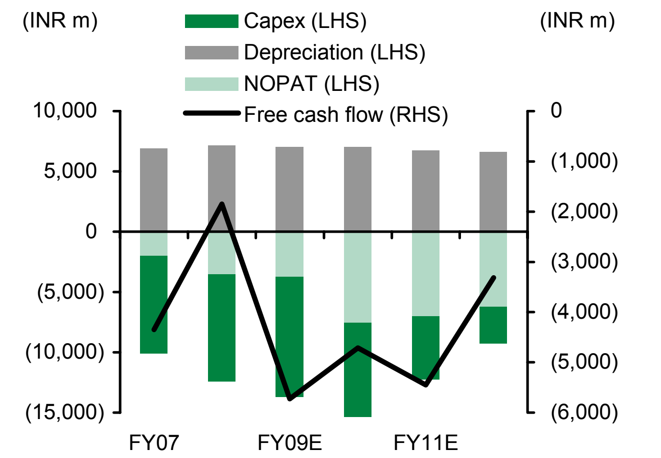

Sources: Mahanagar Telephone Nigam; BNP Paribas estimates

**Exhibit 10: Reducing Revenue And Increasing Costs Would Lead To Decline In EBITDA Margin**



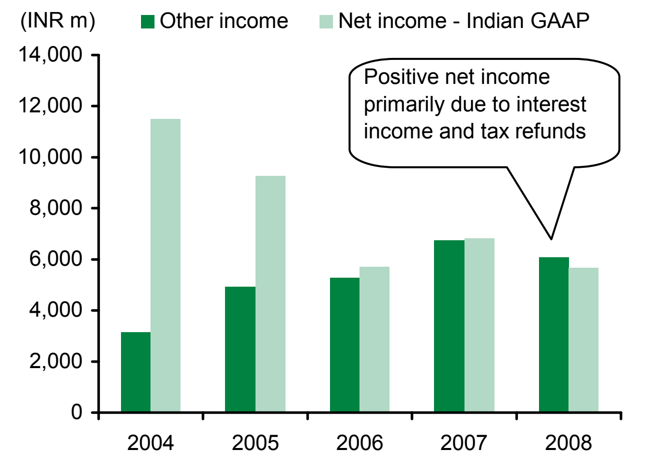

Sources: Mahanagar Telephone Nigam; BNP Paribas estimates

**Exhibit 11: Cash Burn**




Sources: Mahanagar Telephone Nigam; BNP Paribas estimates

**Exhibit 12: Net Income Being Driven By Other Income Like Income Tax Refunds**



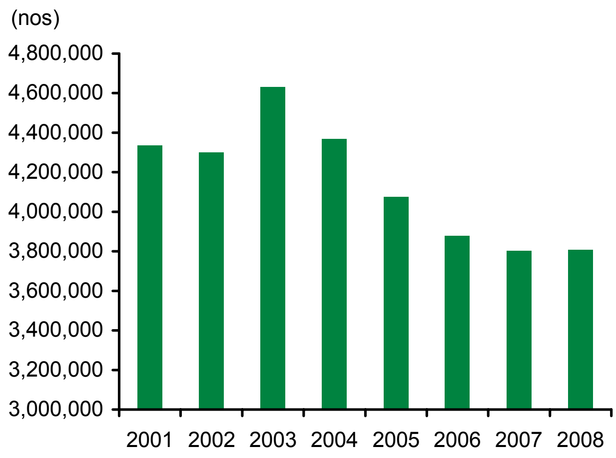

Sources: Mahanagar Telephone Nigam; BNP Paribas

**FALLING REVENUES**

# Wire-line – the lifeline at risk

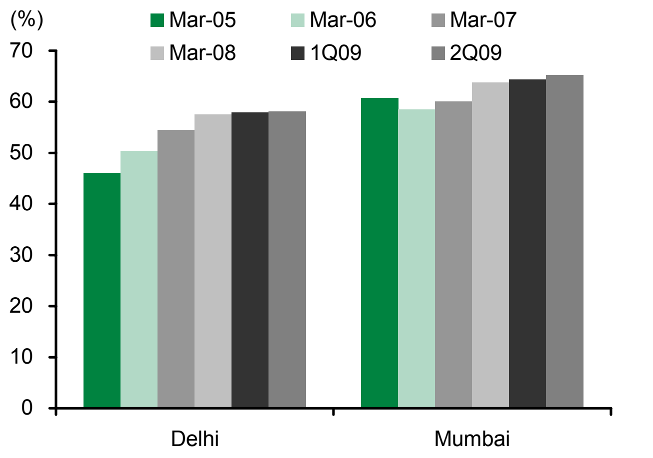
**We believe MTNL will face significant revenue risk as the wire-line segment, which contributes 70% of its revenue, would continue to see a drop in revenue on the back of subscriber loss and reduction in tariffs. The wire-line penetration in the two metro cities (Mumbai and Delhi) has reached a plateau and increasing competition is cannibalizing into MTNL's market share. MTNL is also losing market share in its Public Call Office (PCO) to private operators. The wire-line tariffs are under constant pressure from the declining wireless tariffs.**

**Exhibit 13: MTNL – Wire-line Subscriber Base Declining**




Sources: Mahanagar Telephone Nigam; BNP Paribas

**Exhibit 14: Mumbai And Delhi; Wire-line Penetration Has Peaked**

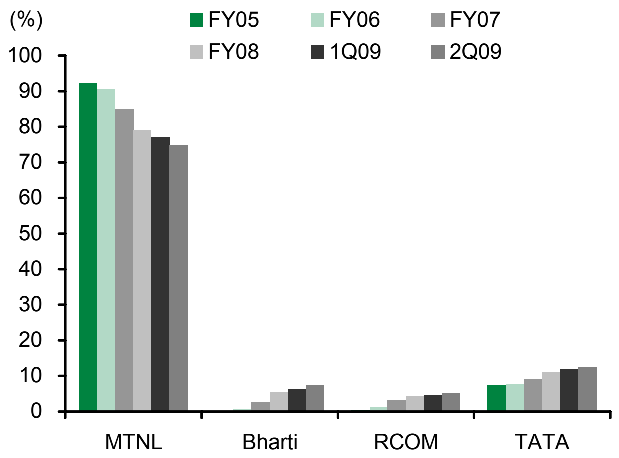



Sources: COAI; AUSPI; Mahanagar Telephone Nigam; BNP Paribas

Wire-line penetration in India has stagnated at 4% levels over the past five years while wireless penetration has increased to 28% from 1%. The wire-line household penetration in Mumbai and Delhi has also reached a plateau, at about 60%. We believe that the wire-line segment would not contribute significantly to the future growth of telecom in India.

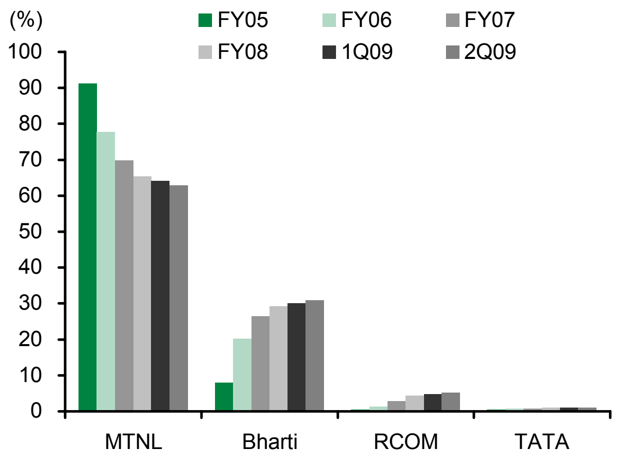
## Losing market share in wire-line

**Exhibit 15: Mumbai Landline – Loosing Market Share**




Sources: COAI; AUSPI; Mahanagar Telephone Nigam; BNP Paribas

**Exhibit 16: Delhi Landline – Losing Market Share**




Sources: COAI; AUSPI; Mahanagar Telephone Nigam; BNP Paribas

MTNL's wireline subscriber base is declining due to market saturation as well as loss of market share to operators like Tata Teleservices in Mumbai and Bharti in Delhi. Government -owned telecom operators like MTNL lead in DSL based broadband subscribers owing to its control over the "last mile" telephone connectivity to the consumer's home on which DSL technology operates. However, adoption of wireless broadband post the upcoming allocation of Broadband Wireless Access spectrum can be a long-term threat to MTNL.

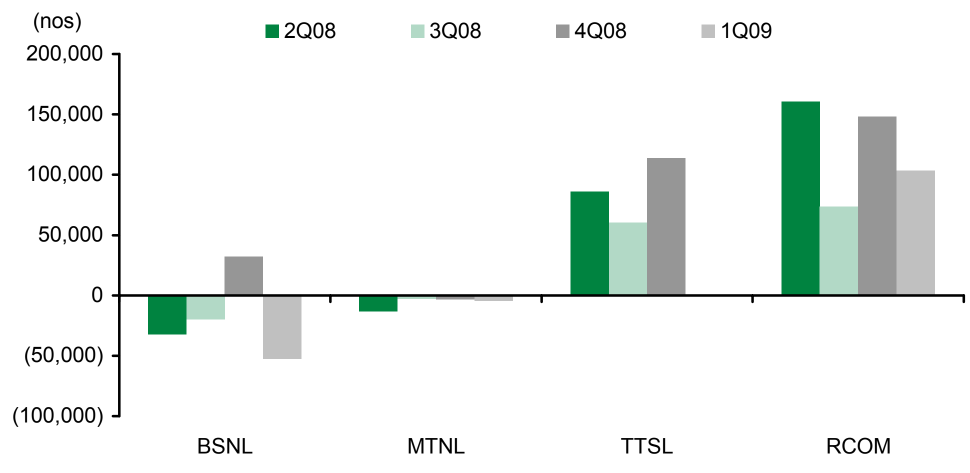
**Wire-line impacted by market saturation, increased competition and reduction in tariffs**

MTNL is losing wire-line market share in both Mumbai and Delhi. The company has lost market share to private operators such as Bharti, RCOM and the Tatas. In Mumbai, MTNL's market share has reduced to 75% in 2QFY09 from 90.6% in FY06. The market has expanded by 14% over FY06-2QFY09 but MTNL's subscriber base reduced by 5%. The company has lost market share primarily to Tata Teleservices, which increased its market share to 12.4% in 2QFY09 from 7.6% in FY06. In Delhi, MTNL's market share has reduced to 62.8% in 2QFY09 from 77.7% in FY06. The market has expanded by 19% but MTNL's subscriber base reduced by 4% over FY06-2QFY09. The company has lost market share primarily to Bharti, which increased its market share from 20.3% in FY06 to 30.9% in 2QFY09.

## PCO outlook gloomy

**Exhibit 17: Quarterly PCO Net Additions; MTNL And BSNL Lose Market Share**

**MTNL and BSNL loosing PCO subscriber base**

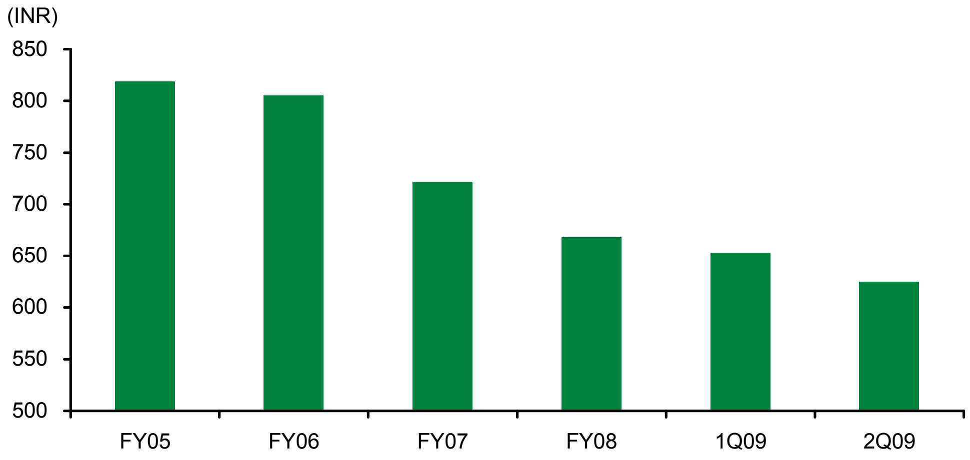



Sources: TRAI; BNP Paribas

PCO or public phone booths account for 6% of MTNL's wire-line subscriber base. MTNL as well as BSNL are losing market share in the PCO market to private operators such as Tata Teleservices and Reliance Communications. We believe that with reducing cost of telephony, rising cellular penetration and higher commissions offered by private operators, MTNL's PCO revenue would continue to see a decline.

## Tariffs would be under constant downward pressure

**Exhibit 18: MTNL – Wire-line ARPU Headed Downward**




Sources: Mahanagar Telephone Nigam; BNP Paribas

**Wire-line tariffs under pressure from reducing wireless tariffs. Average revenue per user would continue to decline**

MTNL's wireline ARPU has declined from INR819 in FY05 to INR625 in 2QFY09. We expect wire-line ARPU to continue to be under pressure as wire-line tariffs will have to align with reducing wireless tariffs.

FALLING REVENUES

# Broadband and Triple-Play – losing steam

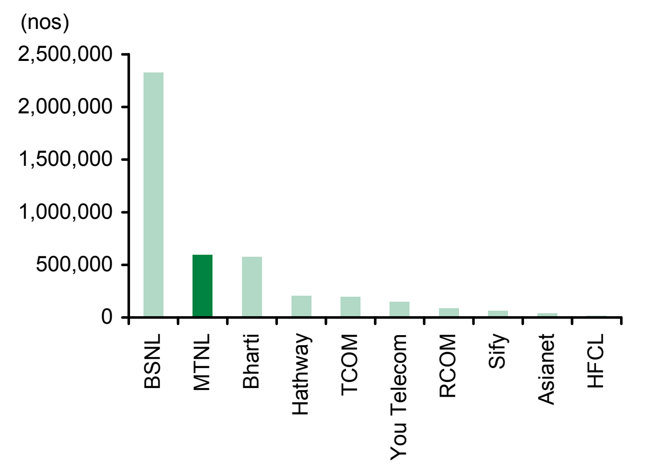
**MTNL is unable to capitalize on the broadband opportunity due to capacity constraints, poor marketing and customer service and competition from private operators. Our checks reveal that there is a delay of up to six months, depending upon the area, to get MTNL broadband connection.**

Internet & Broadband contributes ~7% to MTNL's revenue. Broadband is the fastest growing segment for MTNL with its subscriber base rising by 21.5% in FY08. MTNL provides broadband through DSL and 17.6% of its wire-line subscribers use its DSL broadband connections. Providing broadband connections based on DSL technology have helped MTNL stem its loss of wire-line subscribers as it has limited competition from private operators in DSL connections due to its control of "last mile" telephone connectivity to the consumer's home.

**Broadband is the fastest growing segment; however growth restricted due to capacity constraints. Growth of wireless broadband would be a long term threat**

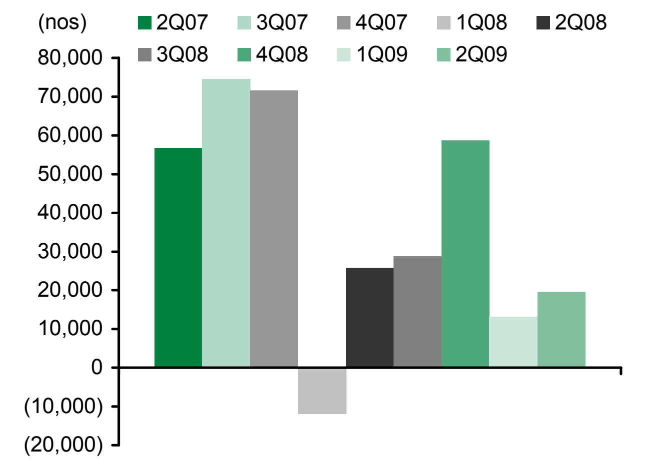
Capacity constraints leading to delays in provisioning broadband connectivity is turning away potential customers from MTNL towards competitors. Private operators are steadily building out their broadband infrastructure and increasing their market shares. Unbundling of local loop could enable private operators realize the value of incumbent's valuable wire-line assets, but do not see it happening in the near future due to protests by the incumbents such as MTNL and BSNL.

**Exhibit 19: Broadband Subscriber Base By Operator**




Sources: TRAI; BNP Paribas

**Exhibit 20: MTNL: Broadband Net Additions Slowing Down**




Sources: Mahanagar Telephone Nigam; BNP Paribas

## Triple Play – lots of promises but unable to deliver

MTNL is one of the first telecom companies to offer Triple Play services i.e. bundled offering of telephone, broadband and IPTV connection. However, this service has had limited success due to high entry cost, limited availability of service and lack of skilled employee base to support these next generation services. The company had only ~7,000 IPTV subscribers as of FY08 and the segment's contribution to overall revenue was negligible. We do not see any significant contribution from this segment going forward.

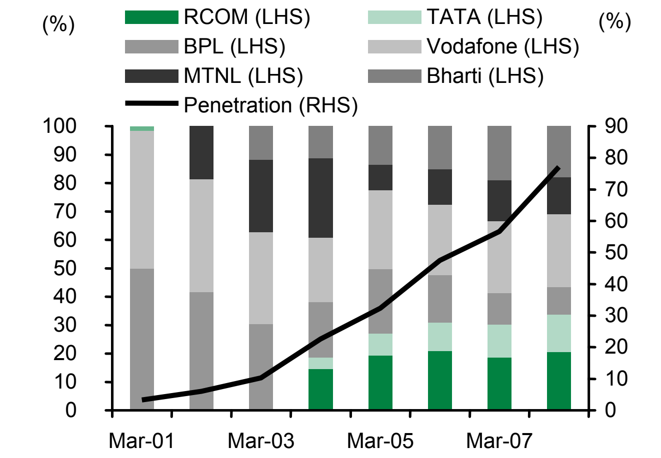
**We do not expect IP TV services to contribute meaningfully to MTNL's top-line**

FALLING REVENUES

# Wireless business: Survival of the fittest

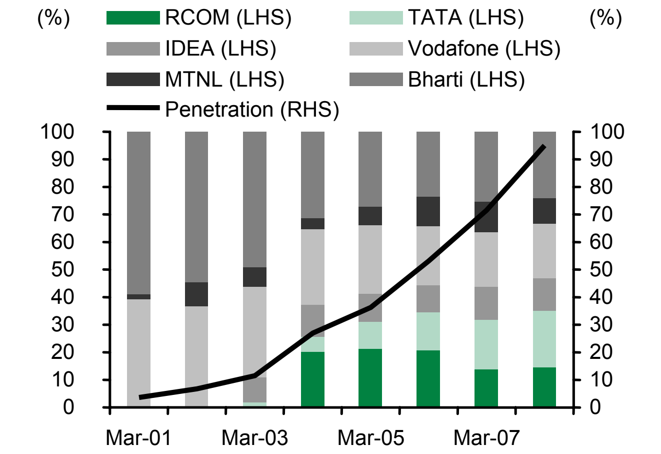
**MTNL provides wireless services in Mumbai and Delhi circles, which have the highest wireless penetration in the country, and are close to saturation. Several new entrants will be launching operations in these two circles, further increasing the competitive intensity. We believe that MTNL will find it extremely difficult to protect its market share as more efficient private operators begin to capture market share by reducing tariffs due to scale economies coupled with superior customer service.**

**Exhibit 21: Mumbai Circle – Wireless Market Share Trend**




Sources: COAI; AUSPI; BNP Paribas

**Exhibit 22: Delhi Circle – Wireless Market Share Trend**



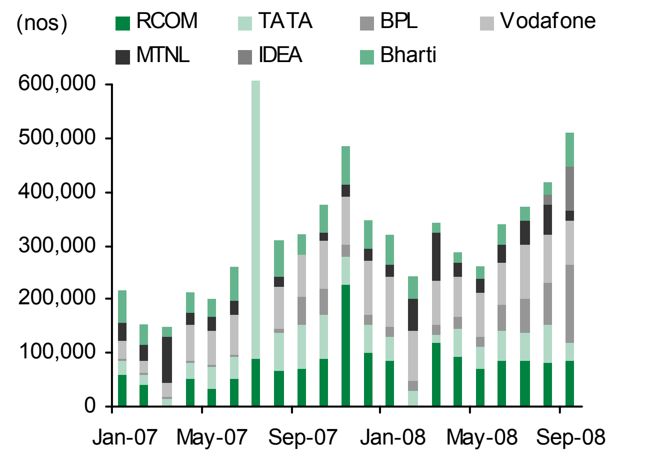

Sources: COAI; AUSPI; BNP Paribas

## High penetration leaves little room for market expansion

MTNL provides wireless services in Mumbai and Delhi circles, which have wireless penetration of 89% and 106%, respectively. Currently there are seven operators in Mumbai and six operators in Delhi. However, the competitive intensity is set to increase with the entry of 8-9 new entrants in both the circles. We believe that with the entry of new operators and falling tariffs, it will be extremely difficult for MTNL to protect its market share. MTNL is an incumbent in both Mumbai and Delhi circles but it currently has the lowest market share in Delhi and is fifth in terms of market share in Mumbai.

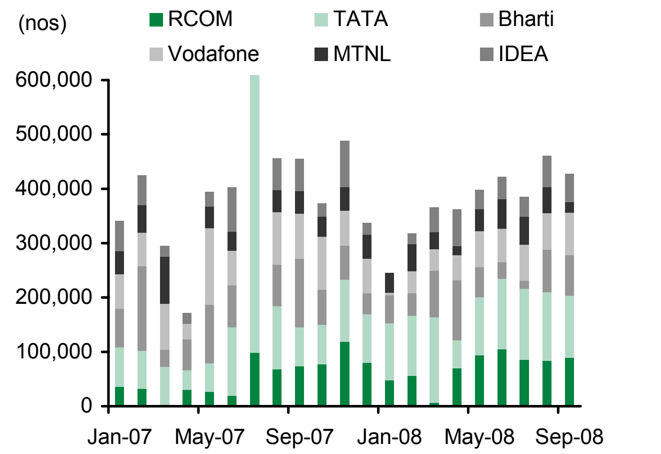
**Intense competition, declining tariffs and high penetration leaves little growth prospects for MTNL's wireless offering**

**Exhibit 23: Mumbai Circle – MTNL Last In Terms Of Net Additions In Last 6 Months**




Sources: COAI; AUSPI; BNP Paribas

**Exhibit 24: Delhi Circle – MTNL Last In Terms Of Net Additions In Last 6 Months**




Sources: COAI; AUSPI; BNP Paribas

INCREASING COSTS

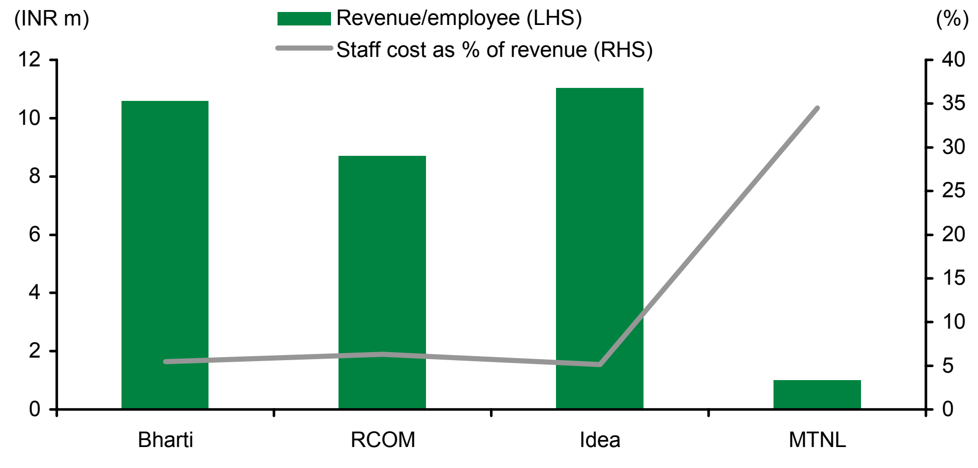
# Employee costs will soar

**MTNL's employee costs will rise with the implementation of the recommendations of the Second Pay Commission. Payment of the salary arrears since 1 January 2007 will be a significant one-time impact on MTNL's financials. MTNL has the highest staff costs as a percentage of sales and the lowest productivity per employee among the telecom companies in India.**

MTNL is a government-owned company and has to comply with pay revisions as mandated by the Department of Public Enterprises. Based on the recommendations of the Second Pay Commission, MTNL has to revise employee salaries with retrospective effect from 1 January 2007. The salary revision will be executed in two phases. In the first phase, the Basic Salary was merged with the Dearness Allowance, which resulted in increasing employee cost by ~17% in FY09. In the second phase, a salary revision of about 15% is expected toward the end of FY09. These staff cost revisions are detrimental to the profitability of the company, as they do not translate into higher revenue.

**Employee cost set to increase as company revises salary based on 2nd Pay Commission recommendation**

**Exhibit 25: Poor Employee Productivity**




Sources: Mahanagar Telephone Nigam; BNP Paribas

**MTNL's revenue per employee is 1/10th of private operators. Employee cost is 35% of revenue compared to 5-6% for private operators**

MTNL has the highest staff cost as a percentage of revenue in the industry. Its employee cost as a percentage of revenue is 35%, which is set to go above 40% with the impending salary revision. It is the least productive company in the sector, with its revenue per employee one-tenth of that of a private operator. The company has 47,422 employees in two circles compared to Bharti, which has 25,616 employees in 22 circles.

INCREASING COSTS

# 3G investments – a drag on free cash flows

**3G spectrum could be a burden for MTNL instead of being a valuable asset as the company would have to match the high spectrum auction bids of private operators, spend on the 3G capex and is likely to fail to monetize its investment due to inability to attract potential 3G subscribers.**

- **Expect aggressive bidding in Mumbai and Delhi:** MTNL will have to match the price paid by private operators through the auction process. Since spectrum availability in Mumbai and Delhi is limited, we expect aggressive bidding by private operators for 3G spectrum in Mumbai and Delhi. This will lead to a significant payout for acquiring the spectrum.

**Exhibit 26: Reserve Price For 3G Spectrum Auction**

| Circle | Reserve price (INR m) |
|---|---|
| Mumbai, Delhi and Category A | 1,600 |
| Kolkata & Category B | 800 |
| Category C | 300 |

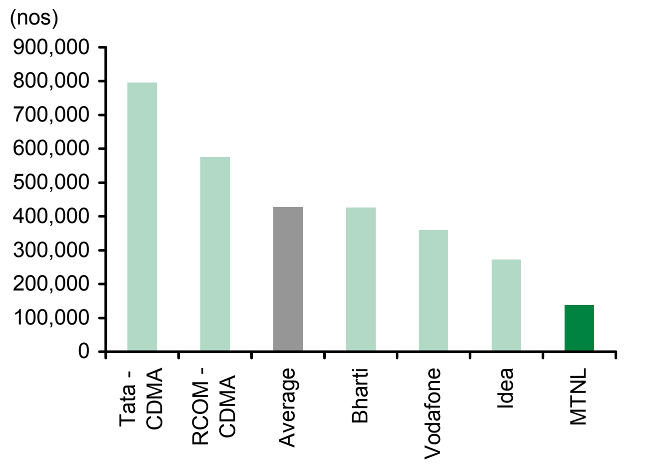
Source: TRAI

**3G will increase costs (Spectrum + Capex + Network operating) but revenue potential limited due to low quality subscribers, low spectrum efficiency**

- **Capex:** Range of 3G spectrum is lower than 2G spectrum and the company would need to incur capex for additional towers and 3G BTS to provide uninterrupted 3G coverage.
- **Smaller and low-end subscriber base will limit revenue potential:** MTNL's subscriber base is smaller than competitors' are, and provides lower ARPU, which reduces its potential to capitalize on the 3G infrastructure. Also, it will be difficult for the company to compete against the private operators in terms of content and customer service.
- **Excess spectrum holding limits use in decongesting voice:** We believe that private operators would look at recovering their investment in 3G by a combination of incremental 3G revenue and decongesting their 2G voice network. However, considering that MTNL has the lowest number of users per Mhz of 2G spectrum in both Mumbai and Delhi, there is no need to decongest its 2G networks using 3G spectrum. MTNL will have to rely on pure play 3G services revenue to recover its investment, which is unlikely to appeal to its low ARPU subscriber base.

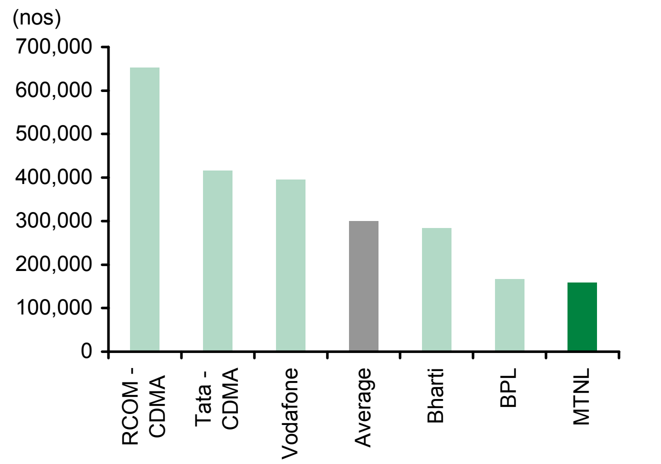
## Inefficient utilization of valuable spectrum

**Exhibit 27: Delhi Circle – Subscribers Per Mhz Of Spectrum**




Sources: TRAI, COAI; AUSPI; BNP Paribas

**Exhibit 28: Mumbai Circle – Subscribers Per Mhz Of Spectrum**




Sources: TRAI, COAI; AUSPI; BNP Paribas

MTNL holds valuable 2G GSM and CDMA spectrum and has also been allotted 3G spectrum ahead of allocation through auction to private operators. However, the company has been unable to utilize this valuable spectrum resource.

**Exhibit 29: Spectrum Efficiency Of Existing And New Wireless Operators In Mumbai And Delhi**

| | | Spectrum Mhz | | Subscribers | | Subscribers per Mhz | | Market share | | Rank | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Operator | State | Delhi | Mumbai | Delhi (nos) | Mumbai (nos) | Delhi (nos) | Mumbai (nos) | Delhi (%) | Mumbai (%) | Delhi | Mumbai |
| Aircel | GSM | 4.4 | 4.4 | | | | | | | | |
| Bharti | GSM | 10.0 | 9.2 | 4,254,967 | 2,615,124 | 425,497 | 284,253 | 22.9 | 16.7 | 1 | 3 |
| BPL | GSM | | 10.0 | | 1,663,904 | | 166,390 | | 10.6 | | 6 |
| Idea | GSM | 8.0 | 4.4 | 2,188,695 | 100,211 | 273,587 | 22,775 | 11.8 | 0.6 | 5 | 7 |
| MTNL | CDMA | 3.8 | 5.0 | | | | | | | | |
| MTNL | GSM | 12.4 | 12.4 | 1,708,644 | 1,969,138 | 137,794 | 158,801 | 9.2 | 12.6 | 6 | 5 |
| RCOM | CDMA | 5.0 | 5.0 | 2,879,284 | 3,263,650 | 575,857 | 652,730 | 15.5 | 20.8 | 4 | 2 |
| RCOM | GSM | 4.4 | 4.4 | | | | | | | | |
| Shyam | CDMA | 2.5 | 2.5 | | | | | | | | |
| Tata | CDMA | 5.0 | 5.0 | 3,976,983 | 2,082,021 | 795,397 | 416,404 | 21.4 | 13.3 | 2 | 4 |
| Tata | GSM | * | 4.4 | | | | | | | | |
| Vodafone | GSM | 10.0 | 10.0 | 3,602,249 | 3,960,444 | 360,225 | 396,044 | 19.4 | 25.3 | 3 | 1 |
| Unitech | GSM | * | 4.4 | | | | | | | | |
| Datacom | GSM | * | 4.4 | | | | | | | | |
| Loop | GSM | * | | | | | | | | | |
| Swan | GSM | * | 4.4 | | | | | | | | |
| S Tel | GSM | * | | | | | | | | | |
| Spectrum holders | | 10 | 15 | 18,610,822 | 15,654,492 | 428,059 | 299,628 | 100.0 | 100.0 | | |

* License holders yet to receive Spectrum
Sources: TRAI; COAI; AUSPI; BNP Paribas estimates

BALANCE SHEET ANALYSIS

# Price to book: Low for a reason

**MTNL looks attractive on a current P/BV of 0.4x. However, an analysis of its balance sheet shows a low Return on Assets of 1% in FY08 and that one-fourth of its net worth is amount recoverable from DoT, which is unconfirmed and outstanding for several years. Cash and cash equivalents are currently INR61 per share but we expect the same to decline to INR39 after payment of salary arrears and 3G spectrum fees.**

**Exhibit 30: MTNL FY08 Balance Sheet**

| | (INR m) | Comments |
|---|---|---|
| **Sources of funds** | | |
| **Shareholders' funds** | | |
| Share capital | 6,300.0 | |
| Reserves and surplus | 112,698.6 | Book value per share is INR88, however CMP and our TP is significantly lower due |
| | 118,998.6 | to low ROE and RNOA. |
| **Loan funds** | | |
| Secured loans | 106.2 | Debt free balance sheet. |
| Unsecured loans | | |
| **Deferred tax liability (net)** | **4,850.0** | |
| **Total** | **123,954.7** | |
| **Application of funds** | | |
| **Fixed assets** | | |
| Gross block (at cost) | 159,386.8 | Return on operating assets was 1% in FY08 and we expect it to be even lower in |
| Less : accumulated depreciation | 95,451.9 | FY09. MTNL has got 3G spectrum and will invest in 3G network deployment; |
| Net block | 63,934.9 | however, we believe that it will be difficult for MTNL to recover its costs on 3G |
| Capital work-in-progress | 9,694.2 | network .Company has significant surplus land holding, any strategic decision on |
| Total | 73,629.0 | sale of land assets could be a risk to our thesis. |
| **Investments** | **4,516.7** | Investment worth INR800m has been impaired in 1HF09 according to 20F filing. |
| *Current assets, loans and advances* | | |
| Cash and bank balances | 33,823.3 | Cash per share is INR54, mostly in fixed deposits. However, MTNL will have to make payment for 3G spectrum and arrears related to salary revision, which will reduce the cash balance to INR32 |
| Sundry debtors | 9,670.9 | No provision made for about INR3.1b outstanding for more than 6 months. |
| Inventories | 1,629.3 | |
| Loans and advances | 96,949.1 | Loans and advances include receivables from DoT INR30.8b, Advance Tax - INR32b, BSNL - INR6b. Receivable from DoT of INR 30.8b is almost 25% of MTNL's net worth. It pertains to amount borne by MTNL for employees transferred from DoT and the amount has been outstanding for several years. Receipt of cash from DoT will be a positive for the company but write-off of this amount would impact profitability significantly. According to the Auditor's report amounts receivable from DoT and BSNL are subject to reconciliation and confirmation |
| Total Current Assets | 142,072.6 | |
| *Less : current liabilities and provisions* | | |
| Current liabilities | 43,403.8 | Current liabilities includes about INR10b of customer deposits and INR10b of employee payables. |
| Provisions | 54,493.1 | Provisions are for employees of about INR37b and for income tax of about INR16b. Difference between Advance Tax and Provision for Tax is INR16b. We believe that the majority of difference would be amount paid but not provided in income statement due to disputes on taxability. |
| Total Current Liabilities | 97,897.0 | |
| **Net Working Capital** | **44,175.7** | |
| **Miscellaneous expenditure** | **1,633.4** | |
| **Total** | **123,954.7** | |

Sources: Mahanagar Telephone Nigam; BNP Paribas estimates

APPENDIX 1

# Devil's advocate: Risks to our investment case

## Sale of land assets

Single biggest risk to our thesis is monetisation of land, network and spectrum assets

MTNL holds valuable land in Mumbai and Delhi, which were transferred to it from Department of Telecom at the time of creation of the company. Any move by the government to create shareholder value by selling any of these assets would be a positive for the stock. However, we do not expect any sale of land holdings in the near future as the company categorically mentions that it does not intend to sell the land in its 20-F filing and that it will need the clearance from the President of India for sale of any property worth more than INR1m.

## Merger with BSNL

The possibility of unlocking of shareholder value via a merger with the other state owned operator BSNL is unlikely in the near term. BSNL's plans to list have been delayed in the current credit crunched markets and due to employee protests. We also believe that the employees of BSNL would resist any merger as it could involve reorganization and possible reduction in workforce.

## Spectrum trading

The TRAI has invited proposals for trading of spectrum. If the regulator implements spectrum trading, MTNL can monetize its spectrum asset by trading, which may provide upside to our valuations.

## Refund from DoT

Refund claim from DoT is sizeable but subject to reconciliation and confirmation

MTNL claims INR30.8b as receivable from DoT pertaining to the amount borne by MTNL for employees transferred from DoT. Amount recoverable is significant and recovery of this amount could be a positive for the company.

## Payout of special dividend

Any payout of special dividend would be a positive for the shareholders. We believe that MTNL's cash levels are set for a decline due to the salary increments and 3G investments. We do not expect MTNL to be in a position to pay special dividends in addition to its annual dividend payout of INR4 due to the declining cash levels.

## Success of 3G services

We believe that it will be difficult for MTNL to monetize its 3G infrastructure due to its small subscriber base, low ARPU subscribers and under utilized 2G network. If the company succeeds in converting a significant number of its low ARPU subscribers into high ARPU 3G subscribers or in attracting new 3G customers, it would be a risk to our thesis.

APPENDIX 2

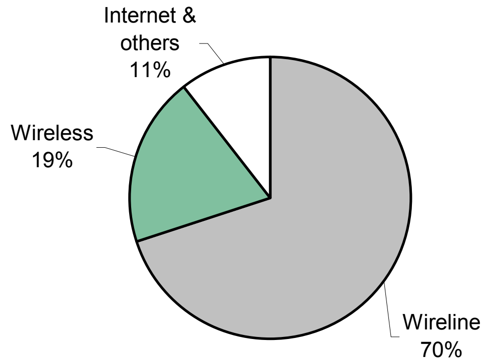
# Key company information

### Exhibit 2.1: Industry Data

| | |
|---|---|
| Industry structure : | Oligopoly |
| Customers : | Wire-line, Wireless & Broadband Subscribers |
| Competitors : | Tata Tele, Reliance Comm, Bharti Airtel, Idea |
| Suppliers : | ITI, Huawei, Ericsson |
| Markets : | India |
| Distributors : | Company offices and distributor network |
| Regulation : | Medium |

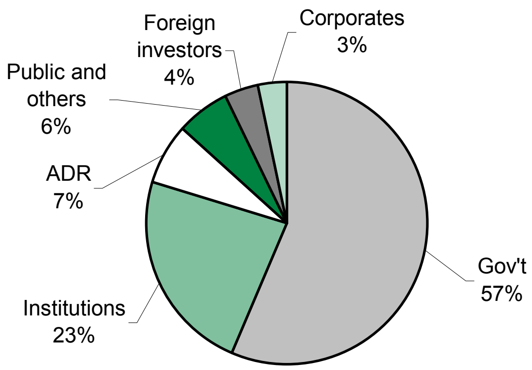
Sources: Mahanagar Telephone Nigam; BNP Paribas

### Exhibit 2.2: Sales Breakdown – FY08



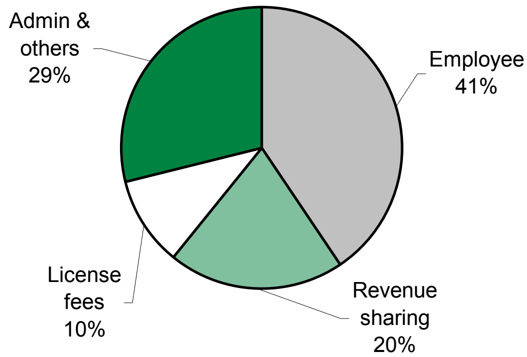

Sources: Mahanagar Telephone Nigam; BNP Paribas

### Exhibit 2.3: Ownership Structure




Sources: Mahanagar Telephone Nigam; BNP Paribas

### Exhibit 2.4: Cost Breakdown – FY08




Sources: Mahanagar Telephone Nigam; BNP Paribas

### Exhibit 2.5: Company Background

MTNL is a government owned telecom operator providing wire-line and wireless telephony services in Mumbai and Delhi, India's financial and national capital cities respectively, which constitutes about 4% of India's population. The company has more than 60% of market share in wire-line telephony in Mumbai and Delhi circles. However, in wireless services, the competition is intense and it is fifth and sixth largest operator in terms of subscriber base in Mumbai and Delhi, respectively. Across these two circles, MTNL has 3.8m wire-line and 3.2m wireless subscribers. The company has recently got 3G spectrum and plans to launch 3G services in a few months.

Sources: Mahanagar Telephone Nigam; BNP Paribas

### Exhibit 2.6: Top Shareholders

| Shareholder | Holding (%) |
|---|---|
| Government of India | 56.3 |
| LIC | 17.4 |
| Reliance Capital | 1.2 |
| Boston Asset Management | 0.7 |
| SBI Funds | 0.4 |
| ICICI Prudential | 0.4 |
| JM Financial | 0.3 |
| IDFC Asset Management | 0.2 |
| DSP Merrill Lynch | 0.2 |
| HDFC Asset Management | 0.1 |
| Mellon Capital | 0.1 |
| HSBC Global Asset Management | 0.1 |
| Union Investment Group | 0.1 |
| Genesis Investment | 0.1 |
| ABN AMRO Asset Management | 0.0 |
| **Total** | **77.5** |

Sources: Mahanagar Telephone Nigam; BNP Paribas

FINANCIAL STATEMENTS

## Mahanagar Telephone Nigam

| Profit and Loss (INR m)<br>Year Ending March | 2007A | 2008A | 2009E | 2010E | 2011E |
|---|---|---|---|---|---|
| Revenue | 49,401 | 47,672 | 45,277 | 43,367 | 43,743 |
| Cost of sales ex depreciation | (13,572) | (12,374) | (14,128) | (14,251) | (13,911) |
| **Gross profit ex depreciation** | 35,829 | 35,299 | 31,149 | 29,117 | 29,832 |
| Other operating income | - | - | - | - | - |
| Operating costs | (27,778) | (28,082) | (26,750) | (29,627) | (30,083) |
| **Operating EBITDA** | **8,051** | **7,217** | **4,398** | **(510)** | **(251)** |
| Depreciation | (6,892) | (7,132) | (7,033) | (7,021) | (6,765) |
| Goodwill amortisation | - | - | - | - | - |
| **Operating EBIT** | **1,159** | **84** | **(2,634)** | **(7,530)** | **(7,016)** |
| Net financing costs | 6,696 | 6,039 | 6,509 | 5,879 | 5,725 |
| Associates | - | - | - | - | - |
| Recurring non operating income | - | - | - | - | - |
| Non recurring items | - | - | - | - | - |
| **Profit before tax** | **7,855** | **6,124** | **3,874** | **(1,651)** | **(1,291)** |
| Tax | (3,267) | (2,260) | (1,102) | 495 | 387 |
| **Profit after tax** | **4,588** | **3,863** | **2,773** | **(1,156)** | **(904)** |
| Minority interests | - | - | - | - | - |
| Preferred dividends | - | - | - | - | - |
| Other items | - | - | - | - | - |
| **Reported net profit** | **4,588** | **3,863** | **2,773** | **(1,156)** | **(904)** |
| Non recurring items & goodwill (net) | - | - | - | - | - |
| **Recurring net profit** | **4,588** | **3,863** | **2,773** | **(1,156)** | **(904)** |
| ***Per share (INR)*** | | | | | |
| Recurring EPS * | 7.28 | 6.13 | 4.40 | (1.83) | (1.43) |
| Reported EPS | 7.28 | 6.13 | 4.40 | (1.83) | (1.43) |
| DPS | 4.00 | 4.00 | 4.00 | 4.00 | 4.00 |
| ***Growth*** | | | | | |
| Revenue (%) | (11.3) | (3.5) | (5.0) | (4.2) | 0.9 |
| Operating EBITDA (%) | (0.6) | (10.4) | (39.1) | neg | neg |
| Operating EBIT (%) | (26.8) | (92.7) | neg | neg | neg |
| Recurring EPS (%) | (19.1) | (15.8) | (28.2) | neg | neg |
| Reported EPS (%) | (19.1) | (15.8) | (28.2) | neg | neg |
| ***Operating performance*** | | | | | |
| Gross margin inc depreciation (%) | 58.6 | 59.1 | 53.3 | 51.0 | 52.7 |
| Operating EBITDA margin (%) | 16.3 | 15.1 | 9.7 | (1.2) | (0.6) |
| Operating EBIT margin (%) | 2.3 | 0.2 | (5.8) | (17.4) | (16.0) |
| Net margin (%) | 9.3 | 8.1 | 6.1 | (2.7) | (2.1) |
| Effective tax rate (%) | 41.6 | 36.9 | 28.4 | neg | neg |
| Dividend payout on recurring profit (%) | 54.9 | 65.2 | 90.9 | neg | neg |
| Interest cover (x) | na | na | na | na | na |
| Inventory days | 49.2 | 56.9 | 42.1 | 41.7 | 42.7 |
| Debtor days | 94.5 | 80.5 | 76.0 | 75.7 | 73.7 |
| Creditor days | 1131.0 | 1285.7 | 1127.2 | 1164.5 | 1236.8 |
| Operating ROIC (%) | 0.8 | 0.1 | (2.0) | (5.9) | (5.6) |
| Operating ROIC - WACC (%) | (15.6) | (16.4) | (18.5) | (22.3) | (22.1) |
| ROIC (%) | 0.8 | 0.1 | (2.0) | (5.8) | (5.5) |
| ROIC - WACC (%) | (15.6) | (16.4) | (18.4) | (22.2) | (21.9) |
| ROE (%) | 4.0 | 3.3 | 2.3 | (1.0) | (0.8) |
| ROA (%) | 0.1 | (0.1) | (0.7) | (2.3) | (2.1) |

** Pre exceptional, pre-goodwill and fully diluted*

| Key Assumptions (INR m) | 2007A | 2008A | 2009E | 2010E | 2011E |
|---|---|---|---|---|---|
| Wireline Subscribers - mn | 3.80 | 3.81 | 3.64 | 3.60 | 3.57 |
| Wireless Subscribers - mn | 2.75 | 3.24 | 3.88 | 4.68 | 5.00 |
| Wireline ARPU | 789 | 712 | 667 | 599 | 581 |
| Wireless ARPU | 300.6 | 257.3 | 222.7 | 199.3 | 189.4 |

| Revenue By Division (INR m) | 2007A | 2008A | 2009E | 2010E | 2011E |
|---|---|---|---|---|---|
| Wireline | 37,642 | 33,385 | 29,824 | 26,039 | 24,993 |
| Wireless | 8,455 | 9,245 | 9,514 | 10,232 | 10,996 |
| Internet & Others | 3,305 | 5,043 | 5,939 | 7,096 | 7,754 |

Sources: Mahanagar Telephone Nigam; BNP Paribas estimates

Revenue would decline due to drop in wire-line subscriber, falling tariffs, increased competition and inability to capitalize on broadband

EBITDA margin will decline due to salary revision. Salary accounts for 40% of total expenditure

We are valuing the company significantly below Book Value due to low ROA and ROE

| Cash Flow (INR m)<br>Year Ending March | 2007A | 2008A | 2009E | 2010E | 2011E |
|---|---|---|---|---|---|
| Recurring net profit | 4,588 | 3,863 | 2,773 | (1,156) | (904) |
| Depreciation | 6,892 | 7,132 | 7,033 | 7,021 | 6,765 |
| Associates & minorities | - | - | - | - | - |
| Other non-cash items | (6,544) | 10,245 | - | - | - |
| **Recurring cash flow** | **4,937** | **21,240** | **9,806** | **5,865** | **5,861** |
| Change in working capital | (1,116) | 3,416 | 937 | 3,605 | 50 |
| Capex - maintenance | (4,052) | (4,442) | (4,980) | (3,903) | (2,625) |
| Capex - new investment | (4,052) | (4,442) | (4,980) | (3,903) | (2,625) |
| **Free cash flow to equity** | **(4,284)** | **15,772** | **782** | **1,664** | **662** |
| Net acquisitions & disposals | - | - | - | - | - |
| Dividends paid | (2,874) | (2,948) | (2,948) | (2,948) | (2,948) |
| Non recurring cash flows | 5,149 | 2,996 | - | - | - |
| **Net cash flow** | **(2,009)** | **15,820** | **(2,166)** | **(1,285)** | **(2,287)** |
| Equity finance | - | - | - | - | - |
| Debt finance | 159 | 172 | - | - | - |
| **Movement in cash** | **(1,850)** | **15,991** | **(2,166)** | **(1,285)** | **(2,287)** |
| ***Per share (INR)*** | | | | | |
| Recurring cash flow per share | 7.84 | 33.71 | 15.56 | 9.31 | 9.30 |
| FCF to equity per share | (6.80) | 25.03 | 1.24 | 2.64 | 1.05 |

Company intends to maintain the dividend per share

| Balance Sheet (INR m)<br>Year Ending March | 2007A | 2008A | 2009E | 2010E | 2011E |
|---|---|---|---|---|---|
| Working capital assets | 123,590 | 108,249 | 107,763 | 107,376 | 107,452 |
| Working capital liabilities | (98,257) | (97,897) | (98,350) | (101,568) | (101,694) |
| **Net working capital** | **25,333** | **10,352** | **9,413** | **5,808** | **5,758** |
| Tangible fixed assets | 72,418 | 73,629 | 76,557 | 77,343 | 75,827 |
| **Operating invested capital** | **97,751** | **83,981** | **85,970** | **83,151** | **81,585** |
| Goodwill | - | - | - | - | - |
| Other intangible assets | 2,248 | 1,633 | 1,633 | 1,633 | 1,633 |
| Investments | - | - | - | - | - |
| Other assets | - | - | - | - | - |
| **Invested capital** | **99,999** | **85,615** | **87,603** | **84,784** | **83,219** |
| Cash & equivalents | (22,349) | (38,340) | (36,174) | (34,889) | (32,603) |
| Short term debt | - | - | - | - | - |
| Long term debt * | 140 | 106 | 106 | 106 | 106 |
| **Net debt** | **(22,209)** | **(38,234)** | **(36,068)** | **(34,783)** | **(32,496)** |
| Deferred tax | 6,182 | 4,850 | 4,850 | 4,850 | 4,850 |
| Other liabilities | - | - | - | - | - |
| Total equity | 116,027 | 118,999 | 118,821 | 114,717 | 110,865 |
| Minority interests | - | - | - | - | - |
| **Invested capital** | **99,999** | **85,615** | **87,603** | **84,784** | **83,219** |
| ** Includes convertibles and preferred stock which is being treated as debt* | | | | | |
| ***Per share (INR)*** | | | | | |
| Book value per share | 184.17 | 188.89 | 188.60 | 182.09 | 175.98 |
| Tangible book value per share | 180.60 | 186.29 | 186.01 | 179.50 | 173.38 |
| ***Financial strength*** | | | | | |
| Net debt/equity (%) | (19.1) | (32.1) | (30.4) | (30.3) | (29.3) |
| Net debt/total assets (%) | (10.1) | (17.2) | (16.2) | (15.7) | (14.9) |
| Current ratio (x) | 1.5 | 1.5 | 1.5 | 1.4 | 1.4 |
| CF interest cover (x) | na | na | na | na | na |

Cash will decline as company pays out salary arrears and 3G spectrum payments – NOT modelled in our assumptions

| Valuation | 2007A | 2008A | 2009E | 2010E | 2011E |
|---|---|---|---|---|---|
| Recurring P/E (x) * | 9.9 | 11.8 | 16.4 | neg | neg |
| Recurring P/E @ target price (x) * | 7.6 | 9.0 | 12.5 | neg | neg |
| Reported P/E (x) | 9.9 | 11.8 | 16.4 | neg | neg |
| Dividend yield (%) | 5.5 | 5.5 | 5.5 | 5.5 | 5.5 |
| P/CF (x) | 9.2 | 2.1 | 4.6 | 7.7 | 7.7 |
| P/FCF (x) | neg | 2.9 | 58.1 | 27.3 | 68.6 |
| Price/book (x) | 0.4 | 0.4 | 0.4 | 0.4 | 0.4 |
| Price/tangible book (x) | 0.4 | 0.4 | 0.4 | 0.4 | 0.4 |
| EV/EBITDA (x) ** | 2.8 | 2.1 | 1.9 | neg | neg |
| EV/EBITDA @ target price (x) ** | 1.4 | 0.6 | (0.6) | neg | neg |
| EV/invested capital (x) | 0.2 | 0.1 | 0.1 | 0.1 | 0.2 |

** Pre exceptional, pre-goodwill and fully diluted*
*** EBITDA includes associate income and recurring non-operating income*

We expect earnings and EBITDA to turn negative in FY10

Sources: Mahanagar Telephone Nigam; BNP Paribas estimates

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## NOTES

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