

INITIATING COVERAGE

Videsh Sanchar Nigam Limited

Hold

Share Data

Market Cap	Rs. 136.89 bn
Price	Rs. 480.3
BSE Sensex	14,862
Reuters	VSNL.BO
Bloomberg	VSNL IN
Avg. Volume (52 Week)	0.34 mn
52-Week High/Low	Rs. 505.7/343.6
Shares Outstanding	285 mn

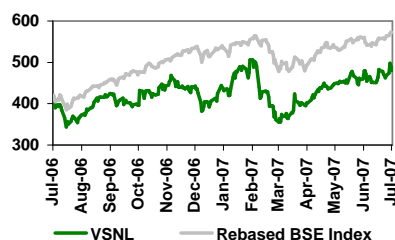
Valuation Ratios

Year to 31 March	2008E	2009E
EPS (Rs.)	19.6	23.0
+/- (%)	12.6%	17.4%
PER (x)	24.5x	20.9x
EV/ Sales (x)	3.0x	2.8x
EV/ EBITDA (x)	12.9x	11.1x

Shareholding Pattern (%)

Promoters	76
FII's	3
Institutions	11
Public & Others	10

Relative Performance



Wait and Watch

Videsh Sanchar Nigam Limited (VSNL) is a leading provider of international telecommunications services and has a strong pan-India long distance presence. The company is experiencing growth in data and internet services and is rapidly growing its retail presence under the Tata Indicom brand. The company plans to de-merge its telecom business; the listing of Flag telecom and the performance of recently acquired TYCO and Teleglobe would fuel future growth for the company. Factors including continuous decline in wholesale voice business, increased competition and high interest expense can limit the upside in company's valuation.

Key Figures (Standalone)

Year to March	FY05	FY06	FY07E	FY08E	FY09E	CAGR (%)
(Figures in Rs mn, except per share data) (FY06-09E)						
Net Sales	33,030	37,810	41,590	44,710	47,839	8.2%
EBITDA	7,691	8,759	9,381	10,507	12,199	11.7%
EBIT	5,251	5,165	5,430	6,036	7,176	11.6%
Margins(%)						
EBITDA	23.3%	23.2%	22.6%	23.5%	25.5%	
EBIT	15.9%	13.7%	13.1%	13.5%	15.0%	
Per Share Data (Rs.)						
EPS	18.7	18.5	17.4	19.6	23.0	7.4%
PER (x)	25.7x	25.9x	27.6x	24.5x	20.9x	

- We expect VSNL to report EBITDA CAGR of 11.7% for FY06-09E driven by increase in data and internet services. Acquisition of Teleglobe and TYCO will further contribute to the top line growth of the business.
- At the current price of Rs. 480.3, the stock is trading at a forward PE of 24.5x for FY08E and 20.9x for FY09E.
- Our target price of Rs. 523.5 has been arrived using a SOTP valuation. In the target price, we have factored in the valuation of surplus land, acquired TYCO & Teleglobe business and investments in Tata Teleservices and Neotel. Given the company is rapidly expanding its domestic and global presence, we initiate coverage with a Hold

Rationale

Enterprise data segment is a major contributor to EBITDA margin

Growth in enterprise data and retail segment

The Indian enterprise data market continues to grow at an annualised rate of 60-70% each year. VSNL's Enterprise Business Unit is a major contributor to EBITDA margin. The company holds a significant potential, led by strong global and domestic demand. Increasing focus on higher margin managed services is likely to lend stability to overall margins, even as competitive pressures continue to keep any further margin expansion at bay. Demand in the retail segment is increasing and the company is planning to launch Wi-max and Wi-fi technologies which will further add to the company's top line growth. VSNL is rapidly growing its retail presence under the Tata Indicom brand through products like high-speed broadband, dial-up Internet, Wi-fi, net telephony and calling cards.

Real estate value between Rs 200 and Rs 240 per share

Unlocking of value in land

VSNL plans to de-merge the telecom business into a separate company. The existing company, which holds the prize-surplus real-estate assets of VSNL, will become the holding company. This proposal, though currently under the government scrutiny, will eventually lead to unlocking of handsome gains for shareholders of VSNL.

The land identified for demerger at different locations measures 773.1 acres, and carries a book value of Rs. 1.64 mn. Currently on a per share basis, rough estimates place the real estate value at anywhere between Rs. 200 and Rs. 240.

FLAG's valuation will have a positive impact on TYCO

Listing of FLAG telecom

Reliance Communications has announced plans to list FLAG, its international bandwidth subsidiary. FLAG's valuation could provide a good comparison for the valuation of Tyco Global Network, the undersea cable network acquired by VSNL. These assets were acquired by VSNL for \$130 mn and its undersea cable capacities are similar to that of FLAG Telecom at 60,000 km.

Going by the preliminary valuation estimates of \$1.5-2 bn for FLAG Telecom, if the listing happens at this value, it will have a positive impact on VSNL too. Even if we assign a value of 50-60% to the assets of FLAG, Tyco's value will work out to be over Rs 125 per share.

Acquisition of Teleglobe: a boost to wholesale voice business

Leveraging TYCO and Teleglobe

Acquisition of Teleglobe, one of the world's most extensive global telecommunications networks company, with undersea cable span of 60,000 km. The company provided VSNL with 16% share of international voice traffic and coverage of over 240 countries and territories to VSNL. By leveraging Teleglobe's extensive global reach, established operational strengths, and depth of carrier relationships worldwide, VSNL is poised to deliver comprehensive portfolio of next-generation carrier and enterprise solutions. This will in turn give a boost to the company's wholesale voice business.

Key Risks

Increasing competition

Increase in FDI limit from 49% to 74% coupled with lower penetration rates in the Indian telecom market, attracted international and domestic players in the industry. Moreover, new National Long Distance (NLD) and International Long Distance (ILD) licenses have been granted by the government to expand the market. All these factors have led to intense competition for VSNL which has put pressure on the tariffs. This has also led to a decline in the market share of the company, as the telecom operators are shifting to competitors or their captive network. Any further decline can have a negative impact on the rating.

Reduction in tariff and decline in market share

Decline in wholesale voice segment

VSNL's wholesale voice segment contributes around 66% to the revenues. While volumes are expected to grow in the future, continuing pricing pressures will keep the segment growth at a low level. One of the factors which will contribute to segment's fall in revenues is the lack of end user relationship. Reliance and Bharti benefit from significant subscriber base, which is absent for VSNL. Tata Teleservices is the only telecom operator that has continued to route its NLD and ILD traffic through VSNL's network. Absence of a subscriber base is posing a major threat to the future growth of the company.

Lack of captive subscriber base

Delay in Carrier Access Code

Carrier Access Code ("CAC") enables subscribers to choose their long distance service provider as against the current scenario where they have to route their

long distance calls through the NLD and ILD network with whom the service provider has an interconnect agreement. This is the only way through which VSNL can increase its subscriber base, as the company does not have a captive subscriber base compared to its peers. Delay in the implementation of CAC can negatively affect the rating.

*Neotel will break even
in 2010*

Pressure from Neotel operations

In 2006, the company acquired a 26% stake in Neotel. The entity launched wholesale international services for voice and IP transit in 2006 and national and international leased line services in early 2007. It also plans to launch retail voice and data services by 1H'2007. The company initially planned to start the operations in 1H'08, which has now been postponed to 2H'08. The late start of operations can put pressure on company's financials as the break even is expected to occur in 2010.

*High interest costs: a
pressure on cash flows*

High interest expense

The company plans to launch Wi-max services, expand network and internet data centres. Further, VSNL investment in Neotel will lead to \$800 mn capex, with a minimum capex of \$500 mn in 2008. All these plans will require huge debt that will in turn lead to high interest expense, and will thus affect the company's cash flows.

*Increasing data and internet
services*

Outlook

VSNL is a leading international telecommunications service provider and enjoys a pan-India long distance presence. Presently, the company is facing reduction in its wholesale voice business. This decrease is being capped by increasing revenues from data and internet services. The company is also planning to introduce Wi-fi and Wi-max, which will further add to the top line growth. VSNL enjoys an international presence, which is strengthened by Teleglobe and TYCO acquisitions. The company has surplus land and is planning to de-merge its telecom business, which will unlock value for its shareholders.

At the current price of Rs. 480.3, the stock trades at a forward PE of 24.5x for FY08E and 20.9x for FY09E. We recommend VSNL to be a Hold with a one year

price target of Rs. 523.5. Our target price has been arrived using a SOTP valuation. Our valuations are based on:

- 5.5x EV/EBITDA for the company's operations
- 1.25x of the acquisition cost for 26% stake in Neotel
- 1.5x of the acquisition cost of Teleglobe and TYCO
- Market value of land, net of capital gain tax
- Valuation of 16.57% stake in Tata Teleservices, based upon Temasek deal
- Finally, the target price is arrived at after ascribing a conglomerate discount of 25% to VSNL

Company Background

Leading player in international telecommunications services

Videsh Sanchar Nigam Limited (VSNL) was incorporated in 1986 and was at that time wholly owned by the Government of India. However, in 2002, Tata Group acquired more than 45% stake in the company. The company is a leading provider of international telecommunications services and has a strong pan-India long distance presence.

VSNL operates in three business segments: wholesale voice, enterprise and carrier data services, and other services. Wholesale voice business consists of International Long Distance (ILD) and National Long Distance (NLD) voice services. Enterprise and carrier data services offer Broadband, Private leased Circuits, Managed Data Networks and Virtual Private Network services. In the retail space, VSNL remains a premier Internet Service Provider, offering a variety of services including connectivity, messaging and Internet telephony.

VSNL's investments include Neotel in South Africa, United Telecom Limited in Nepal, and Tata Teleservices. In 2005, the company acquired Tyco's global submarine network consisting of 60,000 km of fiber optic network which provides seamless connectivity across the globe to carriers and enterprises.

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