

## Spice Communications

Price Band: Rs 41 – 46

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### IPO fact sheet

Particulars	
Issue opens	25 June 2007
Issue closes	27 June 2007
Price band (Rs)	41 – 46
Number of shares (mn)	113.1
Issue size (Rs mn)	4,638 – 5,203
Pre-issue equity (Rs mn)	5,760
Post-issue equity (Rs mn)	6,899
Financial year ending	June

### Issue details

Number of shares	(mn)
Fresh issue	113.1
Employee reservation	2.0
QIB portion	66.7
HNI portion	11.1
Retail portion	33.3

### Financial snapshot

(Rs mn)	FY05	FY06	H1FY07
Sales	6,065.7	6,614.9	3,851.1
Growth (%)	13.1	9.1	16.4*
EBITDA	1,664.8	1,506.0	846.0
Growth (%)	10.7	(9.5)	12.3*
Adj. net income	69.7	(685.8)	(418.1)
FDEPS (Rs)	0.1	(1.2)	(0.8)
EV/EBITDA (x)	23.5	26.0	23.1*
ROCE (%)	4.0	0.3	1.3*

\*Annualised

### Shareholding pattern

(%)	Pre-issue	Post-issue
Promoters	48.8	40.8
FII's*	50.1	41.9
Others	1.1	17.3

\*Includes Telekom Malaysia

## Spicy enough?

Reasonably valued; consolidation may provide further upside

### Issue snapshot

- ❖ Spice Communications is the second largest player in the Punjab circle and the fifth largest in Karnataka, operating in the 900MHz spectrum.
- ❖ Telekom Malaysia, a leading telecom service provider in the Asian region, is a strategic investor in the company and will hold 39.2% of the post-issue equity.
- ❖ Funds from the current public issue are to be used for debt repayment, obtaining NLD and ILD licenses, and strengthening the company's position in existing markets through network expansion.
- ❖ Recent network expansion has led to higher subscriber addition and will likely arrest the steady decline in market share witnessed by the company in recent years; however, in the long term, we expect Spice to lag behind market leaders due to its limited presence.
- ❖ We believe that consolidation is inevitable in the telecom sector in the long term, with space enough for only 3-4 players; Spice remains a lucrative target for acquisition.

### Key concerns

- ❖ The company operates in two circles only, as compared to competitors which have a pan-India presence.
- ❖ Spice has defaulted on payments to its network equipment vendors, due to which legal proceedings have been initiated against the company.
- ❖ Net worth of the company is negative due to past losses. Inability to improve profitability would further erode its net worth.

### Valuation

- ❖ At the lower band of Rs 41, the issue is available at a discount ranging from 40-67% to larger players in the industry, which we believe is reasonable. We thus recommend that investors Subscribe to the issue at the lower end of the price band.

## Company profile

Spice currently has a 23% market share in Punjab and a 7% share in Karnataka

### Operates in Punjab and Karnataka circles

Spice Communications (Spice) is a telecom services provider operating in the Punjab and Karnataka circles. Due to competitive pressures the company's market share and average revenues per user (ARPU) have been on the decline over the past few years. Spice currently has a ~23% market share in Punjab and a ~7% share in Karnataka, making it the second and fifth largest telecom operator in these circles respectively.

### High mobile density states

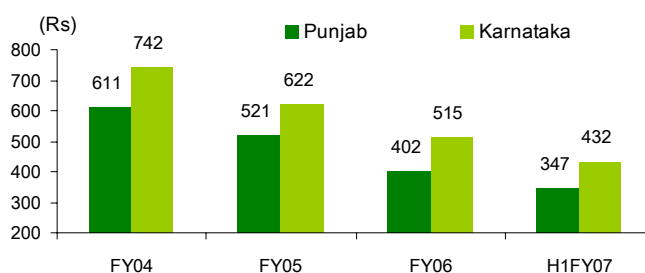
Considering that Punjab and Karnataka represent the agricultural and IT strongholds of the country, both states enjoy a higher per capita income than the all-India average. Mobile teledensity in these states is thus also higher than the ~13% average for India. Bharti Airtel is the leader in terms of subscribers in both circles with a 31% market share in Punjab and 38.9% share in Karnataka respectively.

### Market profile

Particulars	Punjab	Karnataka
Population (mn)	24	57
Mobile teledensity (%)	36.0	21.0
No. of towns with > 5000 population	968	950
Per capita income (US\$)	749	584
Total number of mobile subscribers (mn)	8.5	11.5
Spice's subscribers (mn)	2.0	0.9
Spice's market share (%)	23.1	7.4
Market leader's share (%)	31.0	38.9
Spice ARPU (Rs)	347.0	432.0

Source: Company, Religare Research

### ARPU trend



Source: Company, Religare Research

Fierce competition has led to a progressive decline in market share and per-user revenues

## Objects of the issue

### Utilisation of funds

Particulars	(Rs mn)
Repayment of long-term debt	2,318.8 - 2,601.6
Payment for NLD & ILD licenses and related capex	636.0
Network-related capex	1,776.3
General corporate purposes	-
Issue expenses	-
Total issue size	4,637.6 - 5,203.1

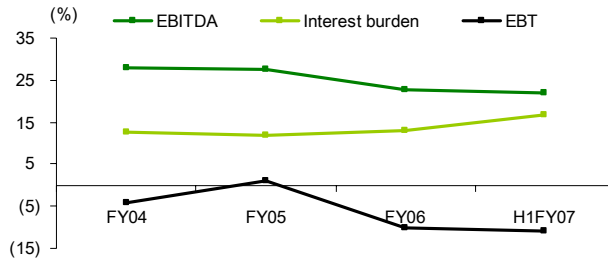
Source: Company, Religare Research

**Financial costs have spiralled from 12.7% of revenues in FY04 to 16.7% in H1FY07**

**Sudden increase in interest burden has raised losses**

Spice has witnessed a considerable increase in its interest burden over FY04-H1FY07 as interests rates have inched up during this period. The company's financial costs have increased from 12.7% of revenues in FY04 to 16.7% in H1FY07. This together with an increase in network operation costs and the resultant dip in operating profits has caused the company to incur losses. We estimate that interest costs savings due to debt repayment from the issue proceeds would total Rs 240mn-250mn.

**Added losses due to higher interest burden (% of revenues)**



Source: Company, Religare Research

**NLD & ILD licenses to decrease operating costs**

Spice also intends to obtain NLD and ILD licenses in order to bring down its operation costs. At present, the company is dependent on other players for national and international calls originating and terminating on its networks.

**Expand network reach to increase subscriber growth**

The company aims to expand coverage in its existing circles of operations. As of March 2007, Spice was present in 537 towns in Punjab and 230 towns in Karnataka. The company has already signed an agreement for network equipment to support its expansion plans. A majority of the fund outflow for expansion is expected to take place in FY09 as per the agreement with the equipment provider.

**Outlook**

**Fierce competition has eroded market position...**

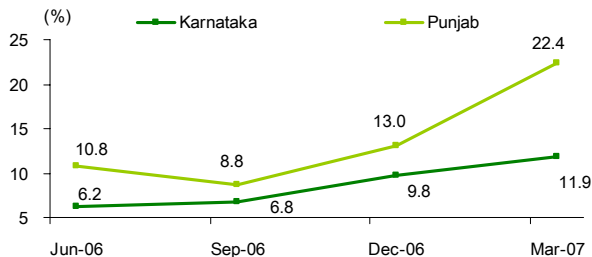
Spice has witnessed a consistent decline in market share (in terms of subscribers) as competition has intensified considerably. The company's market share in the Karnataka circle has declined from 16.4% in FY03 to 6.4% as of April 2007, while that in Punjab has dropped from 40.1% to 26.3% over the same period.

**...but network expansion to sustain current share**

In a bid to salvage the situation the company initiated efforts in FY07 to expand its geographical coverage in these states. In terms of cell sites, Spice's presence in Punjab has increased by 68%, from 809 in June 2006 to 1,358 as of March 2007. In Karnataka too, the number of cell sites has increased from 508 to 1,019, an increase of 101%. This has raised the number of subscriber additions for the company.

**Network expansion in FY07 has helped raise per month subscriber additions**

**Quarterly market share in subscriber net additions**



Source: Company, Religare Research

**Subscriber base to clock 32% CAGR over CY06-CY08 versus 40% for all-India subscribers**

**Future growth may lag behind that of industry**

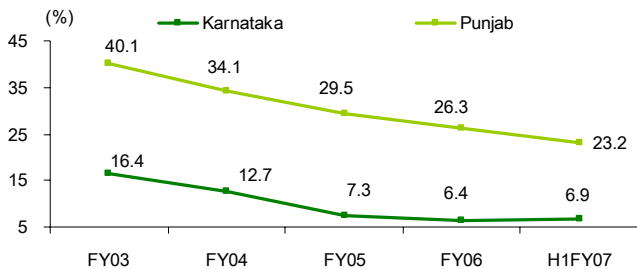
We expect the company's subscriber base to reach ~4.3mn over CY06-CY08, a CAGR of 32% as compared to a ~40% CAGR estimated by us for all-India subscribers. While the expansion of network coverage would sustain Spice's existing market share, we believe that future growth opportunities are limited considering a) the company's limited presence (in only 2 of 23 circles), b) the intensifying competitive landscape, and c) the difficulties it is likely to face in getting a toehold in other circles.

**Limited presence:** Spice is present in the Punjab and Karnataka circles, ahead only of Shyam Telecom and HFCL who have a presence in one circle each. The company has applied for licenses in the remaining 21 circles, but with required spectrum yet to be vacated by defence players despite DoT recommendations, the prospects of entering other circles remains distant. Also, the company would require additional funds for setting up the network in these circles, which would put further pressure on the already stressed balance sheet.

**Intense competition in existing circles:** Spice is facing intense competition in both Punjab as well as Karnataka. Though Punjab has been a stronghold of the company, the market share of players like BSNL and Hutch has been inching up of late, eating into the share of incumbents, namely Spice and Bharti Airtel. In Karnataka too the company's market share has declined over the years, with Spice now being the fifth player by subscriber size, marginally ahead of Tata Teleservices.

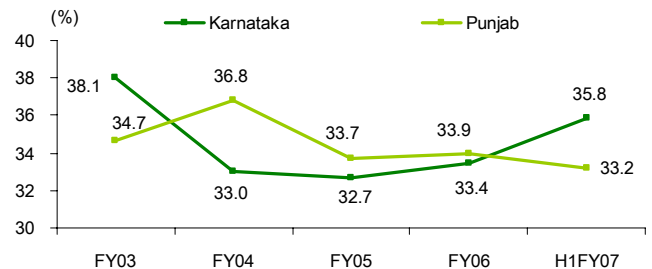
With leaders in both circles already having 70-80% geographical coverage, we believe that the current network expansion would allow the company to stabilise its decreasing market share rather than increase it.

**Spice's market share**



Source: Company, Religare Research

**Bharti's market share**



Source: Company, Religare Research

**Telecom industry moving towards consolidation**

In our opinion, with growing competition and issues like spectrum scarcity and falling ARPUs (especially with roll-outs in rural areas), consolidation in the telecom industry is inevitable in the long term. In such a scenario, players like Spice who have a small presence, but possess valuable spectrum and an established subscriber base would be seen as lucrative takeover targets. Already, there have been rumours of a merger between Idea, Spice and Airtel which would have resulted in an entity with a pan-India presence.

The relaxation of regulatory hurdles to mergers in the telecom industry is currently being contemplated by regulatory bodies. We expect only 3-4 telecom players to dominate the industry post-consolidation.

## Valuation

### Issue at reasonable valuations

When compared to other industry players, we find that Spice's issue is at a considerable discount in terms of per subscriber valuations. We believe that the discount is appropriate considering the following limitations associated with Spice: 1) Present in the Punjab and Karnataka circles only, 2) A much smaller player in terms of subscribers, 3) Negative profitability in past years and already over-burdened balance sheet, and 4) Slower than industry growth anticipated.

### EV/Subscriber valuation

Particulars	Lower band	Upper band
Post-issue number of shares (mn)	689.9	689.9
Price per share (Rs)	41.0	46.0
Market cap (Rs mn)	28,286.9	31,736.6
Enterprise value (Rs mn)	39,093.2	42,542.8
Enterprise value (US\$ mn) @ Rs 40.8/US\$	959.3	1,044.0
Number of subscribers (mn)	3.0	3.0
<b>EV/Subscriber (US\$)</b>	<b>319.0</b>	<b>347.2</b>

Source: Company, Religare Research

### Peer comparison on current subscriber base

At the lower band, the issue is available at a discount ranging from 40-67% to larger players

Company	EV (US\$ mn)	Subscribers (mn)	EV/Sub (US\$)	Discount @ Rs 41 (%)	Discount @ Rs 46 (%)
Bharti Airtel	39,395.2	40.7	966.9	(67.0)	(64.1)
Reliance Comm	26,212.2	29.8	881.1	(63.8)	(60.6)
Hutch-Vodafone deal*	18,800.0	25.3	741.8	(57.0)	(53.2)
Idea Cellular	7,983.3	15.3	522.9	(39.0)	(33.6)
Idea - Public issue	5,700.0	12.4	458.1	(30.4)	(24.2)

Source: Religare Research, \*EV/Sub at the time of the deal

### Peer comparison on CY08E subscriber base

Company	CY08E Subscribers (mn)	EV/Subscribers (US\$)
Bharti Airtel	67.0	587.8
Reliance Communications	52.5	498.9
Hutch	49.0	383.8
Idea Cellular	25.0	319.4
<b>Spice @ Rs 41</b>	<b>4.3</b>	<b>225.6</b>
<b>Spice @ Rs 46</b>	<b>4.3</b>	<b>245.5</b>

Source: Religare Research

### Peer comparison – FY07 valuation multiples

Company	EV/Sales (x)	EV/EBITDA (x)
Bharti Airtel	8.6	22.3
Reliance Communication	7.2	18.6
Idea Communication	7.4	22.3
Spice @ Rs 41	5.1	23.1
Spice @ Rs 46	5.5	25.1

Source: Bloomberg consensus estimates, Religare Research

**Stronghold in mobile dense  
Punjab circle and takeover  
prospects to unlock value**

On an EV/EBITDA basis, Spice does appear expensive when compared to industry peers. However, in our opinion, the operating profit of the company is suppressed due to the rentals for leased networks, whereas depreciation expenses (in case of owned networks) would have left EBITDA intact.

**Subscribe at lower end of price band**

India is one of the fastest growing telecom markets in the world. While Spice is a marginal player in this market, we believe the company offers a good investment opportunity due to its stronghold in the higher per-capita income Punjab circle and the possibility of value unlocking should it become a takeover target. We recommend that investors Subscribe to the issue at Rs 41, the lower end of the price band.

## Key concerns

**Past defaults on payment to equipment suppliers**

In the past Spice has defaulted on agreed payments to equipment vendors like Motorola and Siemens AG, who have initiated legal proceedings against the company.

**Negative net worth**

As of December 2006, Spice had a negative net worth of Rs 1.6bn, indicating a pre-issue negative book value of Rs 2.9/share. The company's net worth has consistently been eroded in the past as losses have increased each year. Though the public issue would restore the company's net worth to positive levels, future losses could reverse this position.

## Financials

### Profit and Loss statement

(Rs mn)	FY04	FY05	FY06	H1FY07
Revenues	5,363.4	6,065.7	6,614.9	3,851.1
Growth (%)	8.5	13.1	9.1	16.4
EBITDA	1,504.1	1,664.8	1,506.0	846.0
Growth (%)	(9.4)	10.7	(9.5)	12.3
Depreciation	1,235.1	1,239.3	1,458.2	709.6
EBIT	269.0	425.5	47.8	136.5
Growth (%)	(44.9)	58.2	(88.8)	470.5
Interest	677.3	715.7	862.2	638.1
Other income	177.4	361.6	141.5	88.4
EBT	(230.8)	71.5	(672.9)	(413.2)
Growth (%)	N/A	N/A	N/A	N/A
Tax	-	1.8	13.0	4.9
Effective tax rate	-	2.5	(1.9)	(1.2)
Adj net income	(230.8)	69.7	(685.8)	(418.1)
Growth (%)	N/A	N/A	N/A	N/A
Shares outstanding (mn)	551.9	551.9	551.9	551.9
FDEPS (Rs)	(0.4)	0.1	(1.2)	(0.8)
DPS (Rs)	-	-	-	-
CEPS (Rs)	1.8	2.4	1.4	0.5

Source: Company, Religare Research

### Cash flow statement

(Rs mn)	FY04	FY05	FY06	H1FY07
Net income	(230.8)	69.7	(685.8)	(418.1)
Depreciation	1,235.1	1,239.3	1,458.2	709.6
Other adjustments	317.1	262.8	187.7	(41.5)
Changes in WC	369.6	(358.4)	389.0	(73.0)
Operating cash flow	1,690.9	1,213.3	1,349.0	176.9
Capital expenditure	(1,186.8)	(1,324.8)	(1,861.5)	(1,756.8)
Investments	-	-	-	-
Other investing inc/(exp)	80.8	81.8	(118.5)	327.3
Investing cash flow	(1,106.1)	(1,243.0)	(1,980.0)	(1,429.4)
Free cash flow	584.9	(29.6)	(631.0)	(1,252.6)
Issue of equity	-	-	-	-
Issue/repay debt	(54.1)	55.7	4.7	1,052.7
Dividends paid	-	-	-	-
Others	-	-	-	-
Financing cash flow	(54.1)	55.7	4.7	1,052.7
Beg. cash & cash eq	1,542.2	2,073.0	2,099.1	1,472.7
Chg in cash & cash eq	530.8	26.1	(626.4)	(199.8)
Closing cash & cash eq	2,073.0	2,099.1	1,472.7	1,272.9

Source: Company, Religare Research

### Recommendation history

Date	Event	Target (Rs)	Reco
25-Jun-07	IPO Note	NA	Subscribe

Source: Religare Research

### Balance sheet

(Rs mn)	FY04	FY05	FY06	H1FY07
Cash and cash eq	2,073.0	2,099.1	1,472.7	1,272.9
Accounts receivable	517.3	578.7	487.8	544.5
Inventories	-	0.5	-	6.6
Others current assets	642.8	749.9	520.4	898.3
Current assets	3,233.1	3,428.1	2,480.8	2,722.3
LT investments	-	-	-	-
Net fixed assets	9,163.6	9,000.7	9,406.9	10,376.5
CWIP	-	-	-	-
Total assets	12,396.7	12,428.8	11,887.8	13,098.9
Payables	1,899.3	1,912.6	1,973.3	2,625.0
Others	-	-	-	-
Current liabilities	1,899.3	1,912.6	1,973.3	2,625.0
LT debt	10,815.7	10,761.6	11,073.1	12,079.1
Other liabilities	-	-	-	-
Equity capital	5,519.4	5,519.4	5,519.4	5,519.4
Reserves	(5,837.7)	(5,764.8)	(6,678.1)	(7,124.7)
Net Worth	(318.3)	(245.4)	(1,158.7)	(1,605.3)
Total liabilities	12,396.7	12,428.8	11,887.8	13,098.9
BVPS (Rs)	(0.6)	(0.4)	(2.1)	(2.9)

Source: Company, Religare Research

### Financial ratios

	FY04	FY05	FY06	H1FY07*
EBITDA margin (%)	28.0	27.4	22.8	22.0
EBIT margin (%)	5.0	7.0	0.7	3.5
Net profit margin (%)	(4.3)	1.1	(10.4)	(10.9)
FDEPS growth (%)	N/A	N/A	N/A	N/A
Receivables (days)	34.4	33.0	29.4	24.5
Inventory (days)	0.1	0.0	0.0	0.2
Payables (days)	115.3	114.7	107.2	109.0
Current ratio (x)	1.7	1.8	1.3	1.0
Interest coverage (x)	0.7	1.1	0.2	0.3
Debt/equity ratio (x)	NA	NA	NA	NA
ROE (%)	NA	NA	NA	NA
ROCE (%)	2.6	4.0	0.3	1.3
ROAE (%)	2.2	3.4	0.3	1.1
EV/Sales (x)	7.3	6.4	5.9	5.1
EV/EBITDA (x)	26.0	23.5	26.0	23.1
P/E (x)	NA	NA	NA	NA
P/BV (x)	NA	NA	NA	NA
P/CEPS (x)	22.5	17.3	29.3	38.8

Source: Company, Religare Research \*Annualised; Valuation multiples at Rs 41/share

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