Company

2 September 2010 | 9 pages

Bharti Airtel (BRTI.BO)

Equity

Indian Safari in Kenya

- **Insights into the Kenyan market** — We spoke with a senior industry professional in Kenya. The focus was on industry trends and competitive dynamics in context to Bharti's entry which has recently made aggressive forays by announcing a 50% tariff cut. Key takeaways include:
- **High interconnect rate was a barrier for smaller telcos** — Kenya's current penetration is 50% with physical penetration 15% lower. Safaricom (Vodafone holds a 40% stake) is the largest telco with a 77% sub share. O/G MoU is 100mins with on-net/off-net split at 92/8% (even higher 1 year back when termination rate was 8KSH). This has now however reduced to 1.7KSH, which allows narrowing on-net/off-net tariff gap (50% higher), helping smaller operators (Bharti) effectively compete. Regulator plans to eventually eliminate it.
- **Why initial focus on a small contributor like Kenya?** – Safaricom's high sub share (helped by early introduction of per-sec billing) makes it vulnerable to a strong competitor. Sub stickiness (2% churn) from money transfer app (M-Pesa) however will be the key challenge for Bharti to overcome. In addition, it also has to protect Zain's high proportion of post-paid base (helped by early focus on high ARPU subs) from the recently introduced MNP.
- **What can Bharti do?** — Focus on network and branding holds key to turnaround (low tariffs already matched by Safaricom). Safaricom has 2300 sites v/s ~800 for Zain. While matching full coverage is likely to take 18-24 mths, given 70/30 urban/rural sub split, matching Safaricom's "high rev generating" sites can be achieved faster (this holds true for other Zain countries too).
- **Kenyan Safari on an elephant** — Zain has been underinvested and Bharti can potentially do much more notwithstanding competition from well entrenched operators (MTN/Millicom/Vodacom). We believe that the elephant is still at the outskirts of the jungle. The tariff cuts could be a test case for other low share; high potential Zain markets.

Hold/Low Risk	2L
Price (01 Sep 10)	Rs337.30
Target price	Rs350.00
Expected share price return	3.8%
Expected dividend yield	0.7%
Expected total return	**4.5%**
Market Cap	Rs1,280,907M US$27,216M

Price Performance (RIC: BRTI.BO, BB: BHARTI IN)

Statistical Abstract

Year to 31 Mar	Net Profit (RsM)	Diluted EPS (Rs)	EPS growth (%)	P/E (x)	P/B (x)	ROE (%)	Yield (%)
2009A	84,700	22.31	26.4	15.1	4.2	32.2	0.3
2010A	91,791	24.17	8.3	14.0	3.1	25.6	0.7
2011E	85,073	22.40	-7.3	15.1	2.6	18.9	1.0
2012E	95,808	25.23	12.6	13.4	2.3	18.4	1.5
2013E	106,771	28.12	11.4	12.0	2.0	17.9	2.1

Source: Powered by dataCentral

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Fiscal year end 31-Mar	2009	2010	2011E	2012E	2013E
Valuation Ratios					
P/E adjusted (x)	15.1	14.0	15.1	13.4	12.0
EV/EBITDA adjusted (x)	8.9	8.2	7.7	6.9	5.9
P/BV (x)	4.2	3.1	2.6	2.3	2.0
Dividend yield (%)	0.3	0.7	1.0	1.5	2.1
Per Share Data (Rs)					
EPS adjusted	22.31	24.17	22.40	25.23	28.12
EPS reported	22.31	24.17	22.40	25.23	28.12
BVPS	80.06	108.94	127.51	147.01	167.08
DPS	1.00	2.45	3.40	5.10	7.15
Profit & Loss (RsM)					
Net sales	369,616	389,489	424,048	463,172	497,186
Operating expenses	-265,518	-288,915	-324,726	-350,321	-372,670
EBIT	**104,098**	**100,574**	**99,321**	**112,851**	**124,516**
Net interest expense	-11,613	5,784	523	938	7,387
Non-operating/exceptionals	589	1,386	2,517	4,395	6,682
Pre-tax profit	**93,074**	**107,744**	**102,361**	**118,184**	**138,586**
Tax	-6,615	-13,959	-16,378	-21,273	-30,489
Extraord./Min.Int./Pref.div.	-1,759	-1,994	-910	-1,102	-1,325
Reported net income	**84,700**	**91,791**	**85,073**	**95,808**	**106,771**
Adjusted earnings	84,700	91,791	85,073	95,808	106,771
Adjusted EBITDA	150,086	161,031	172,796	192,285	208,643
Growth Rates (%)					
Sales	36.8	5.4	8.9	9.2	7.3
EBIT adjusted	36.2	-3.4	-1.2	13.6	10.3
EBITDA adjusted	32.6	7.3	7.3	11.3	8.5
EPS adjusted	26.4	8.3	-7.3	12.6	11.4
Cash Flow (RsM)					
Operating cash flow	**140,432**	**153,423**	**176,786**	**160,280**	**168,488**
Depreciation/amortization	45,988	60,457	73,474	79,435	84,127
Net working capital	1,404	379	10,588	-10,732	-9,667
Investing cash flow	**-143,340**	**-75,325**	**-228,048**	**-53,938**	**-35,841**
Capital expenditure	-146,406	-79,909	-231,163	-57,369	-45,519
Acquisitions/disposals	2,066	0	0	0	0
Financing cash flow	**7,230**	**-45,154**	**-17,118**	**-29,281**	**-37,838**
Borrowings	3,795	-54,181	0	-5,000	-5,000
Dividends paid	0	-10,464	-14,526	-21,789	-30,547
Change in cash	**4,321**	**32,945**	**-68,380**	**77,061**	**94,808**
Balance Sheet (RsM)					
Total assets	**596,391**	**646,409**	**747,204**	**807,314**	**871,226**
Cash & cash equivalent	49,070	77,034	8,654	85,715	180,524
Accounts receivable	28,528	24,335	39,547	38,508	35,018
Net fixed assets	449,499	496,483	644,391	622,325	583,717
Total liabilities	**281,742**	**204,220**	**233,557**	**218,545**	**204,908**
Accounts payable	0	0	0	0	0
Total Debt	118,800	64,619	64,619	59,619	54,619
Shareholders' funds	**314,649**	**442,189**	**513,647**	**588,768**	**666,318**
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	40.6	41.3	40.7	41.5	42.0
ROE adjusted	32.2	25.6	18.9	18.4	17.9
ROIC adjusted	28.9	20.8	16.4	16.1	17.1
Net debt to equity	22.2	-2.8	10.9	-4.4	-18.9
Total debt to capital	27.4	12.8	11.2	9.2	7.6

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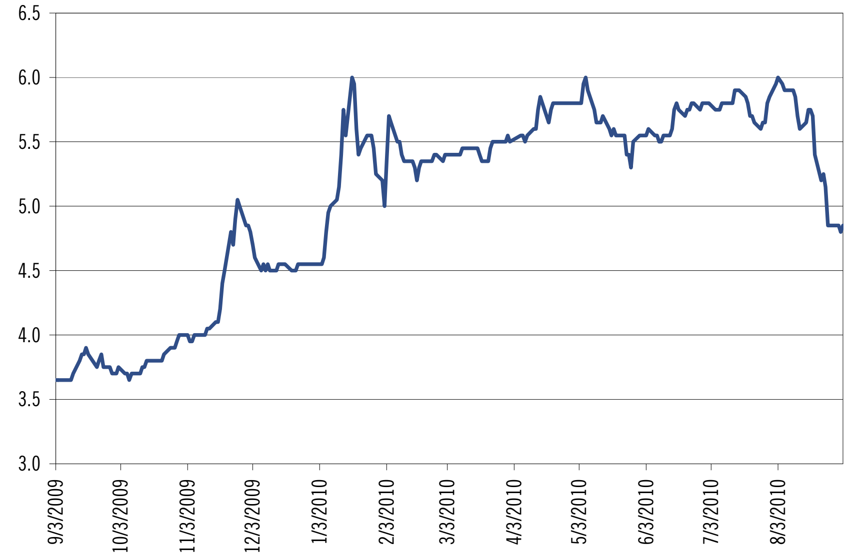
Safaricom's share price has taken a hit after Bharti announced 50% tariff cut – familiar story?

Figure 1. Safaricom's share price movement



Source: Citi Investment Research and Analysis

80% revenue share, EBITDA margins are far higher compared to the next biggest operator (Zain)

Figure 2. Safaricom financials

US$ m	Mar-08	Mar-09	Mar-10
Revenues	727	832	992
YoY growth		*14.5%*	*19.1%*
Opex	308	387	432
Interconnect	32	49	53
% of sales	*4.4%*	*5.9%*	*5.4%*
Airtime	93	125	154
% of sales	*12.8%*	*15.0%*	*15.5%*
Network	68	89	94
% of sales	*9.4%*	*10.7%*	*9.5%*
Acquisition and retention	80	84	78
% of sales	*11.0%*	*10.1%*	*7.8%*
Other	35	40	53
SG&A	86	107	128
Payroll	37	51	66
Marketing	27	27	31
General	21	29	32
% of sales	*11.8%*	*12.9%*	*12.9%*
Total opex	394	494	559
EBITDA	**333**	**330**	**432**
Margins	*45.8%*	*39.7%*	*43.6%*
YoY growth		*-0.9%*	*31.0%*
PBT		181	248
Tax		56	69
Effective tax rate		*31.1%*	*27.7%*
Net income		**124**	**179**
FCF		(12)	72

Source: Citi Investment Research and Analysis

Multi-SIM usage similar to India but more on account of the past differential between on-net and off-net tariffs (now 50% higher). Physical penetration is 30% lower

Figure 3. Operational KPIs

	Mar-08	Mar-09	Mar-10
Subscribers (m)	10.23	13.36	15.79
Net adds		261	203
Sub mkt share		79.1%	78.3%
Revenue mkt share		83.0%	84.3%
ARPU (US$)		5.6	5.4
Churn (%)	22.4%	24.3%	27.2%

Source: Citi Investment Research and Analysis

Safaricom has 2300 cell sites compared to ~800 cell sites of Zain. While Bharti will take 18-24 months to match the coverage, the 70/30 urban/rural sub split means that initial focus on the higher revenue generating sites should help it effectively compete with Safaricom

Figure 4. Coverage details

	Mar-08	Mar-09	Mar-10
Total BTS	1,558	1,899	2,302
YoY increase		341	403
3G	116	301	607
WiMax			140
US$ m			
Capex	293	282	206
3G	11	43	31
WiMax			17
2G	125	100	90
Transmission	25	27	10
Core network	40	35	12
Other	92	77	47
% of sales	*40.3%*	*33.9%*	*20.8%*

Source: Citi Investment Research and Analysis

Zain's reported ARPU is higher than Safaricom given its early focus on high ARPU post-paid subscribers and is part of the reason for Bharti's early focus on Kenya despite it contributing only 1% to EBITDA (MNP has been introduced)

Figure 5. Zain historical financials

US$ m	CY2007	CY2008	CY2009
Revenues	194	162	154
Growth %		-16%	-5%
EBITDA	32	-25	7
EBITDA margins (%)	*16.4%*	*-15.2%*	*4.4%*
ARPU(US$)	7	6	4

Source: Citi Investment Research and Analysis

Bharti Airtel

Company description

Bharti Airtel, through its group companies, provides cellular-phone services in all of India's 23 telecom circles. The group also provides fixed-line phone services, broadband, long-distance and enterprise services. It is listed on The Stock Exchange, Mumbai (BSE) and The National Stock Exchange of India Limited (NSE). Major shareholders are Bharti Telecom, SingTel and Vodafone.

Investment strategy

We rate Bharti shares Hold/Low Risk (2L). Bharti is in our view best positioned to capture Indian wireless growth profitably. However, the recently released TRAI recommendations on spectrum policy and M&A (if accepted by the DoT) have once again exposed the sector to pricing competition and pressure on the B/S from cash outgo related to one-time spectrum charges and renewals. The fragmented 3G spectrum has also increased risks of a sharp tariff cut in the as yet untouched post-paid segment (tariffs are 30% higher than pre-paid), especially with RCOM’s win in Mumbai/Delhi.

Zain remains the key swing factor for Bharti’s earnings. While it can potentially do much more with Zain, which has been losing ground (Africa EBITDA down 16% in 2009) due to funding constraints, our MTN analyst believes that the physical limitations of rolling-out network in Africa may pose challenges in replicating Bharti’s “minutes factories” model. A full debt funding of Zain however has reduced the overhang of a potential rights issue.

Valuation

Our target price of Rs350 comprises (i) core business value of Rs359 based on Sep10 DCF. We estimate value depletion from Zain at Rs18/share. We add the Indus stake value (Rs27/share) but also reduce the potential cash outgo (Rs18) related to one-time excess spectrum charges and license renewal fees.

Risks

Our quantitative risk-rating system, which tracks 260-day share price volatility, rates Bharti shares as Low Risk. We are comfortable with this for the following reasons: 1) Bharti has a track record of profitability and execution and 2) strong FCF generation.

Downside risks include competition-led tariff pressures. Upside risk could emerge from faster than expected consolidation, sharper than expected pullback in MOUs and an earlier-than-expected turnaround of Zain.

Appendix A-1

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Bharti Airtel (BRTI.BO)

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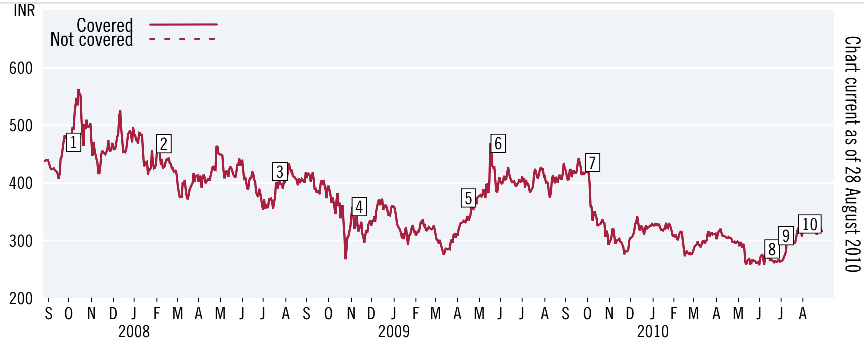
Fundamental Research

Analyst: Gaurav Malhotra, CFA
Covered since June 18 2010



Date	Rating	Target Price	Closing Price
1 8-Oct-07	1L	*600.00	492.40
2 12-Feb-08	1L	*575.00	427.90
3 24-Jul-08	1L	*535.00	398.98
4 13-Nov-08	1L	*450.00	315.63
5 16-Apr-09	1L	*420.00	334.38
6 28-May-09	1L	*465.00	397.60
7 8-Oct-09	*2L	*370.00	334.65
8 18-Jun-10	2L	*303.00	264.85
9 8-Jul-10	2L	*300.00	280.85
10 11-Aug-10	2L	*350.00	319.70

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

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