

Indian Wireless

Please dial after some time...!

9 July 2010
BSE Sensex: 17834

Telecom

Bharti and Idea stocks were up 9-12% in today's trading session with a belief that negative news flow in the sector is over and that consensus upgrades would start coming in post the 1QFY11 results later this month. On the contrary, we believe Indian telcos were trading close to the historical lows in terms of 1yr fwd P/E and had consolidated at these levels for considerable time, pushing the case for a technical 5-10% rally before resilient 1QFY11 results. We have been highlighting it consistently that based on replacement cost, stocks are trading in a fair range but the risk reward is still not favorable enough to start accumulating Bharti and Idea. Key risks for the sector are i) next round of tariff cuts close to the MNP rollout; and ii) clarity on spectrum management norms by the regulator. We believe the recent relief rally in telcos is not sustainable as none of the risks are behind, and it is too soon to think that the tide has turned. Maintain cautious stance on the sector.

Key highlights of our take on the sector are:

- **Margin expansion story is some time away:** We agree that the headline tariffs have been fairly stable over the past 6 months but, the circle level promotional tariffs are expected to pressurize RPM marginally. Nevertheless, we estimate that RPM decline would moderate in the next 2 quarters as the MNP rollout has been pushed back to 3QFY11 now. However, action on the postpaid tariff front post MNP rollout (Oct '10) to grab/retain the share of top-end customers could be a strong hit on blended realizations (even if 2 license holders who are yet to launch services surrender their license as talked by media). Also, higher marketing and promotional expenses for 3G and MNP would hit margins of incumbents in 2HFY11. Further, higher fuel prices are certain to increase the network operating cost for rural areas where towers are running on back-up power for most part of the day. Net-net we believe there is more pain to come up though the immediate quarterly results could be resilient.
- **3G/BWA services - Latent demand would surface only at affordable rates:** Margin upside from 3G/BWA data business is unlikely to have meaningful impact till FY12 in our view. RIL's plans of focussing on broadband business could depress margins of data business and if regulations permit then roll out VoIP services could be a serious threat to incumbents. In addition, massive scale in data business is possible (on the lines of wireless boom in India) only if services and equipments are affordable - largely dependent on the parallel development of telecom equipment market and the whole ecosystem. We believe significant uptick in the near-term is unlikely.
- **Impending regulatory hurdles:** With the war of words continuing between the GSM incumbents and regulatory bodies (TRAI and DoT) over proposed TRAI recommendations, the final decision is to be vetted by the cabinet ministers. We believe this will take some time to come through and the potential cash outflow for spectrum in current form could be Rs35-40bn and Rs12bn for Bharti and Idea. The net impact of the TRAI recommendations on FY12 earnings could be to the tune of ~9% for Bharti to ~19% for Idea even after factoring in the benefits of lower license fees. In addition, spectrum re-farming on license renewal could be a huge negative for DCF valuation as capex would likely increase 2014 onwards for incumbents. It is hard to believe that TRAI recommendations would be entirely scrapped as the stocks have returned back to the pre-TRAI recommendation levels despite lack of clarity.

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- **Strategic deals in wireless/tower cos could lead to re-rating of stocks:** Balance sheets of all the Indian telcos have been stretched by huge outflow for 3G/BWA spectrums. Fund raising to de-leverage in the medium term via stake sales in either the core business or towercos are one of the possible way out. As reflected in the corporate announcements related to RCOM, plans of hiving off tower business and possible 26% stake sale in wireless business to clean-up the balance sheet has led to serious re-rating of the stock over the last 1 month. But, the re-rating has happened because balance sheet was a concern for RCOM. But, funding was never an issue for Bharti Airtel and any equity dilution is a negative for a minority holder. Value unlocking (if any) from Bharti Infratel/Indus is a potential upside risk for Bharti/Idea.

□ Valuations & View

- **Bharti:** At Rs 305, Bharti trades at FY12E EV/EBITDA of ~6.9x for the core business post the Zain deal (including Rs36 for Indus Towers and assuming EBITDA of US\$5.2bn). This is at a 44% premium to average multiples of 4.8x for diversified global and emerging market peers. For a diversified emerging market (relatively low penetration) telco with near-term pressure in the domestic market and significant execution risk, we believe a multiple of ~6.0-6.5x is reasonable. This implies a price range of Rs255-280. We believe any re-rating would be led by only faster than expected synergies from the international acquisitions.
- **Idea:** At Rs67, is trading at 7.5x FY12EV/EBITDA which is at a premium to integrated player and market leader Bharti. We believe the pure play wireless operator with new circles still making losses is the most exposed to any regulatory changes and competition in postpaid business. Still, given the spectrum portfolio (ideal acquisition target with substantial pan India presence) and management track record the company has always traded at a premium.

Exhibit 1: Global Valuations Comparison

	Local Currency	CMP (LC)	Market cap (US\$ mn)	Enterprise value (US\$ mn)	P/E (x)		EPS growth (%)		ROE (%)	EV/EBITDA (x)		EBITDA growth (%)	
					FY11E	FY12E	FY11E	FY12E		FY11E	FY12E	FY11E	FY12E
Bharti Airtel	INR	308.3	25,049	26,319	16.1	16.0	(15.8)	1.1	18.1	7.9	7.0	(1.2)	12.8
RCOM	INR	193.1	8,512	16,004	22.2	16.5	(20.9)	34.3	6.4	9.5	7.7	(0.2)	23.6
Idea Cellular	INR	66.9	4,724	6,442	NM	32.2	(71.8)	184.0	4.7	9.8	7.2	11.5	36.9
China Mobile *	CNY	68.7	203,526	169,950	11.7	11.4	3.5	2.6	21.5	4.8	4.7	5.0	3.1
China Unicom *	CNY	8.9	30,881	39,869	33.9	25.1	(39.6)	34.7	3.1	4.3	3.9	0.6	9.7
NTT Docomo	JPY	141,200	69,792	68,467	11.8	11.4	0.7	2.8	10.5	3.9	3.9	(1.2)	0.0
SK Telecom *	KRW	164,000	11,039	16,546	9.3	8.8	NM	4.9	13.2	4.6	4.5	9.5	2.9
America Movil *	MXN	31.6	100,084	105,527	12.7	11.5	4.6	10.9	45.1	7.8	7.2	9.0	8.9
MTN *	ZAR	109.5	26,713	28,849	11.0	9.3	9.8	18.2	23.2	4.4	3.9	2.6	13.1
Vodafone	GBP	1.4	114,818	168,727	9.1	9.0	0.6	1.3	9.1	7.6	7.5	(0.9)	0.7
Orascom *	USD	0.9	4,577	9,355	8.0	8.5	28.2	(5.5)	20.6	4.0	3.7	3.4	7.3
AT&T *	USD	24.6	145,184	212,471	10.9	10.1	6.3	8.5	13.0	5.0	4.8	2.9	3.9
Verizon *	USD	26.8	75,700	177,886	11.9	11.3	(6.7)	6.0	12.4	5.1	4.9	1.3	3.0

Source: IDFC Securities estimates for Bharti, Idea and RCOM; Bloomberg for the rest. Note: * = December year-end; FY11E = CY10 and FY12E = CY11. Priced at 9 July 2010.

Exhibit 2: Potential impact of TRAI recommendations on earnings of Bharti / Idea

Impact on EPS (Rs m)	Bharti Airtel		Idea Cellular	
	FY11	FY12	FY11	FY12
Consolidated Revenue	426,768	474,163	151,462	190,117
Operating expenditure	265,371	292,459	114,673	138,660
Consolidated EBITDA (current est)	161,397	181,704	36,789	51,456
Margin (%)	37.8	38.3	24.3	27.1
Benefit from lower license fee	2,006	4,931	1,060	2,700
Higher spectrum charge	(2,960)	(3,270)	(826)	(1,020)
License fee of passive infra	(982)	(1,407)	(422)	(506)
Adjusted EBITDA (est)	159,461	181,958	36,602	52,630
Margin (%)	37.4	38.4	24.2	27.7
D&A	(71,491)	(81,744)	(26,468)	(31,045)
Additional amortisation of 2G cost	(5,546)	(5,546)	(1,751)	(1,751)
Interest income / (expense)	(151)	(5,464)	(8,270)	(11,329)
Additional interest (@9%)	(3,362)	(3,362)	(1,169)	(1,169)
Others	1,276	1,310	0	0
PBT	80,187	87,153	(1,056)	7,337
Tax rate (%)	17.5	20.0	13.0	21.0
Provision for taxes	(14,033)	(17,431)	137	(1,541)
Minority interest	(1,985)	(2,092)	0	0
PAT	64,170	67,630	(919)	5,796
Wtd shares	3,798	3,798	3,300	3,300
Adjusted EPS	16.9	17.8	(0.3)	1.8
Current EPS estimate	19.2	19.6	0.5	2.2
% impact due to TRAI norms	(12.1)	(9.2)	NM	(19.2)

Source: IDFC Securities Research

Exhibit 3: Additional one-time payout by Bharti for excess 2G spectrum

Circles	Type	Dt of license	Tenure left	Spectrum				One time charge	Pro-rated
				Total	900Mhz	1800Mhz	3G price		
Delhi	Metro	29/11/1994	4	10	8	2	33,169	35,159	7,698
Mumbai	Metro	28/09/2001	11	9.2	0	9.2	32,471	21,820	12,235
Maharashtra	A	28/09/2001	11	8.2	0	8.2	12,578	5,182	2,906
Gujarat	A	28/09/2001	11	6.2	0	6.2	10,761	0	0
Andhra P	A	12/12/1995	5	10	7.8	2.2	13,731	14,281	3,866
Karnataka	A	15/02/1996	6	10	7.8	2.2	15,799	16,431	4,595
Tamil Nadu	A	29/11/1995	5	9.2	6.2	3	14,649	9,844	2,648
Kolkata	Metro	29/11/1994	4	8	6.2	1.8	5,443	1,959	429
Kerala	B	28/09/2001	11	6.2	0	6.2	3,125	0	0
Punjab	B	12/12/1995	5	7.8	7.8	0	3,220	1,546	418
Haryana	B	28/09/2001	11	6.2	0	6.2	2,226	0	0
UP (East)	B	10/02/2004	14	7.2	6.2	1	3,646	729	495
UP (West)	B	28/09/2001	11	6.2	6.2	0	5,140	0	0
Rajasthan	B	22/04/1996	6	8.2	6.2	2	3,210	1,323	382
Madhya P	B	28/09/2001	11	8	0	8	2,584	930	522
WB & An	B	11/02/2004	14	6.2	4.4	1.8	1,236	0	0
Himachal Pr	C	12/12/1995	5	6.2	6.2	0	372	0	0
Bihar	C	10/02/2004	14	9.2	6.2	3	2,035	1,367	929
Orissa	C	10/02/2004	14	8	6.2	1.8	970	349	237
Assam	C	08/07/2004	14	6.2	1.8	4.4	415	0	0
North East	C	12/12/2005	15	6.2	4.4	1.8	423	0	0
J&K	C	10/02/2004	14	6.2	6.2	0	303	0	0
Total				168.8	97.8	71	167,506	110,921	37,360

Source: TRAI, IDFC Securities Research

Exhibit 4: Additional one-time payout by Idea for excess 2G spectrum

Circles	Type	Dt of license	Tenure left	Total Spectrum	900Mhz	1800Mhz	3G price	One time charge	Pro-rated
Delhi	Metro	05/10/2001	11	8	0	8	33,169	11,941	6,707
Mumbai	Metro	05/12/2006	16	4.4	0	4.4	32,471	0	0
Maharashtra	A	12/12/1995	5	9.8	8	1.8	12,578	12,679	3,433
Gujarat	A	12/12/1995	5	6.2	6.2	0	10,761	0	0
Andhra P	A	19/12/1995	5	8	6.2	1.8	13,731	4,943	1,343
Karnataka	A	09/04/1996	6	6.2	6.2	0	15,799	0	0
Tamil Nadu	A	25/01/2008	18	4.4	0	4.4	14,649	0	0
Kolkata	Metro	25/01/2008	18	4.4	0	4.4	5,443	0	0
Kerala	B	12/12/1995	5	8	6.2	1.8	3,125	1,125	305
Punjab	B	09/04/1996	6	7.8	7.8	0	3,220	1,546	444
Haryana	B	12/12/1995	5	6.2	6.2	0	2,226	0	0
UP (East)	B	05/10/2001	11	6.2	0	6.2	3,646	0	0
UP (West)	B	12/12/1995	5	8	6.2	1.8	5,140	1,851	501
Rajasthan	B	05/10/2001	11	6.2	6.2	0	3,210	0	0
Madhya P	B	12/12/1995	5	8	6.2	1.8	2,584	930	252
WB & An	B	25/01/2008	18	4.4	0	4.4	1,236	0	0
Himachal Pr	C	05/10/2001	11	4.4	0	4.4	372	0	0
Bihar	C	06/12/2006	16	4.4	0	4.4	2,035	0	0
Orissa	C	25/01/2008	18	4.4	0	4.4	970	0	0
Assam	C	25/01/2008	18	4.4	0	4.4	415	0	0
North East	C	25/01/2008	18	4.4	0	4.4	423	0	0
J&K	C	25/01/2008	18	4.4	0	4.4	303	0	0
Total				132.6	65.4	67.2	167,506	35,014	12,984

Source: IDFC Securities Research

Exhibit 5: Working for revenue erosion post MNP (based on Vodafone India data)

	3QFY10	Post MNP (15% drop)	Post MNP (25% drop)
Average postpaid subs (m)	5.5	5.5	5.5
Postpaid MoU (minutes)	1,030	1,061	1,082
Assumed elasticity (%)		20.0	20.0
Postpaid RPM (Rs)	0.76	0.65	0.57
Pricing pressure (%)		(15.0)	(25.0)
Postpaid ARPU (Rs)	785	687	618
Postpaid revenue (Rs m)	13,004	11,385	10,240
% change		(12.5)	(21.3)
Prepaid revenue (Rs m)	41,617	41,617	41,617
Total service revenues (Rs m)	54,621	53,002	51,857
% change		(3.0)	(5.1)

Source: Company data, IDFC Securities Research

Exhibit 6: Working for margin erosion post MNP (based on Vodafone India data)

	3QFY10	Post MNP (15% drop)	Post MNP (25% drop)
Total service revenues (Rs m)	54,621	53,002	51,857
Postpaid revenues (Rs m)	13,004	11,385	10,240
Prepaid revenues (Rs m)	41,617	41,617	41,617
Blended RPM (Rs)	0.51	0.49	0.48
Postpaid RPM (Rs)	0.76	0.65	0.57
Prepaid RPM (Rs)	0.46	0.46	0.46
Total minutes (m)	107,111	107,623	107,964
Operating cost (Rs m)	42,309	42,309	42,309
Operating cost/min (Rs)	0.40	0.39	0.39
Wireless EBITDA (Rs m)	12,312	10,693	9,549
Postpaid EBITDA (Rs m)	6,264	4,476	3,220
Prepaid EBITDA (Rs m)	6,048	6,217	6,329
% change		(13.1)	(22.4)
Blended margins (%)	22.5	20.2	18.4
Postpaid margins (%)	48.2	39.3	31.4
Prepaid margins (%)	14.5	14.9	15.2
Margin erosion (bp)		237bps	413bps

Source: Company data, IDFC Securities Research

Exhibit 7: Sensitivity of margin decline to usage elasticity and pricing declines

	(%)	Elasticity				
		10	15	20	25	30
RPM decline	15	(262) bp	(249) bp	(237) bp	(224) bp	(212) bp
	20	(355) bp	(339) bp	(323) bp	(307) bp	(291) bp
	25	(451) bp	(432) bp	(413) bp	(394) bp	(375) bp
	30	(551) bp	(529) bp	(507) bp	(485) bp	(463) bp
	35	(654) bp	(630) bp	(605) bp	(581) bp	(557) bp

Source: IDFC Securities Research

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