

MARCH 04, 2011

UPDATE

Coverage view: **Cautious**

Price (Rs): **93**

Target price (Rs): **90**

BSE-30: **18,490**

Any tower sale deal would offer just value realization and not value creation.

Recent press reports indicate that RCOM is in talks with three bidders for the company's tower assets residing in the Reliance Infratel subsidiary. We note that RITL towers have very little external tenancy and hence headline deal valuation (or speculative news flow on the same) would reflect the tower lease terms that RCOM agrees to in the transaction. It's a sale-and-lease-back transaction, essentially – a high/low tower sale valuation would reflect the high/low lease rentals agreed upon. Reiterate SELL.

Company data and valuation summary

Reliance Communications

Stock data

52-week range (Rs) (high,low)	208-84
Market Cap. (Rs bn)	199.1

Shareholding pattern (%)

Promoters	67.9
FII's	9.0
MFs	0.8

Price performance (%)

	1M	3M	12M
Absolute	(18.6)	(33.0)	(43.2)
Rel. to BSE-30	(20.4)	(27.6)	(48.4)

Forecasts/Valuations

	2011	2012E	2013E
EPS (Rs)	6.9	7.9	11.3
EPS growth (%)	(65.2)	15.0	43.6
P/E (X)	13.6	11.8	8.2
Sales (Rs bn)	204.3	234.0	271.6
Net profits (Rs bn)	15.6	18.7	27.4
EBITDA (Rs bn)	67.0	74.9	87.5
EV/EBITDA (X)	8.0	7.2	5.9
ROE (%)	3.1	3.7	5.4
Div. Yield (%)	0.0	0.0	0.0

The news – RCOM in talks with three bidders for the sale of towers

Press reports indicate that RCOM has shortlisted three bidders for the sale of its telecom tower assets. Two of the bidders, as per the press report, are American Tower Company and Viom Networks. The press report also indicates bids in the range of Rs3.9-4.5 mn per tower for a tower base of 54,000 towers with an average tenancy of 1.1, held in the Reliance Infratel subsidiary, 94.5% owned by RCOM. Note that RCOM had indicated a tower base of 48,139 and a tenancy of 1.7 at end-August 2009 in its DRHP filed in Sep 2009. We believe that the lower tenancy as reported in the press indicates the 'full-rental equivalent tenancy (FRET)' on RITL towers – essentially, a CDMA player also leasing a GSM tenancy on the same tower (or a 2G players leasing a 3G tenancy) does not pay full-rentals for the 2nd tenancy – it only pays an additional loading charge, in the range of 5-20% of the base rental. With a bulk of RITL's towers hosting both RCOM CDMA and GSM tenants and marginal external tenancy, a FRET of 1.1 sounds reasonable.

The good – RCOM gets some much-needed cash infusion

At nearly 5X net debt to TTM EBITDA as at end-Dec 2010, RCOM has a stretched balance sheet. The need to refinance maturing debt and heavy interest payment burden has impacted the company's ability to target wireless revenue share improvement (through network investments and price interventions) aggressively. Not just that, initial porting data suggests that RCOM has been the worst-hit – a clear reflection of the perceived poor network quality that RCOM offers. Under various scenarios that we evaluate in Exhibit 1, RCOM's net debt to EBITDA (FY2012E) can get reduced to 2.1-2.8X post the tower sale transaction.

The bad – it's not value creation, it's just value realization

Press reports assign a transaction value of Rs3.9-4.5 mn EV/tower, we find this expensive considering a 1.1 average tenancy. However, we believe that such a transaction is possible if RCOM agrees to a higher-than-market pricing in the sale-and-lease-back transaction (which is what such deals are, fundamentally). Our scenario analysis (see Exhibit 1) suggests a post-deal fair value of Rs76-79/share for RCOM if the transaction is done at 8XFY2012E EBITDA and Rs90-95/share, if at 10X. Retain SELL; TP Rs90.

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Exhibit 1: Sale value of a sale-and-lease back transaction depends on the lease-back conditions
Impact of tower sale under various scenarios on RCOM's fair value

	Scenario 1	Scenario 2	Scenario 3	Scenario 4
Transaction assumptions				
# of towers	54,000	54,000	54,000	54,000
EV/tower (Rs mn)	3.90	3.90	4.50	4.50
EV (Rs mn)	210,600	210,600	243,000	243,000
EV/EBITDA (X)	8	10	8	10
EBITDA (Rs mn) (A)	26,325	21,060	30,375	24,300
Implied EBITDA per tower per month (Rs)	40,625	32,500	46,875	37,500
Tenancy	1.3	1.3	1.3	1.3
Implied EBITDA per tenant per month (Rs)	31,250	25,000	36,058	28,846
Implied rental per tenant per month (at 65% margin) (Rs)	48,077	38,462	55,473	44,379
RCOM valuation post sale				
FY2012E EBITDA pre-sale (Rs mn) (B)	74,950	74,950	74,950	74,950
Net debt pre-sale (Rs mn)	338,238	338,238	338,238	338,238
EV/EBITDA at our current TP of Rs90	7.1	7.1	7.1	7.1
Net debt/EBITDA pre sale (X)	4.5	4.5	4.5	4.5
FY2012E EBITDA post-sale (Rs mn) (a)	49,941	54,943	46,094	51,865
Net debt post-sale (b)	139,221	139,221	108,603	108,603
EV/EBITDA post sale (c)	6.0	6.0	6.0	6.0
Net debt to EBITDA post sale (X)	2.8	2.5	2.4	2.1
EV post sale	300,298	330,374	277,163	311,866
Equity value post-sale (Rs mn)	161,077	191,153	168,560	203,263
Equity value per share (Rs)	76	90	79	95

Note:

(a) EBITDA post-sale = EBITDA pre-sale (B) - 95% of towerco EBITDA (A).

(b) Net debt post sale = net debt pre sale - 94.5% of the transaction EV.

(c) EV/EBITDA post sale should be lower than EV/EBITDA pre-sale given that higher EV/EBITDA tower business is out of the SOTP.

Source: Kotak Institutional Equities estimates

Exhibit 2: Per tower EV of >US\$100,000 makes sense only at a tenancy of 2 or above at market rentals
Analyzing a tower deal at an EV of US\$100,000/tower at various tenancy levels

EV/tower (US\$)	100,000							
EV/tower (Rs '000)	4,500							
Implied equity value/ tower (Rs '000)	3,350							
Gross capital invested (Rs '000)	2,300							
Debt (Rs '000)	1,150							
Equity (Rs '000)	1,150							
EV/GCI (X)	1.96	1.96	1.96	1.96	1.96	1.96	1.96	1.96
P/B (X)	2.91	2.91	2.91	2.91	2.91	2.91	2.91	2.91
Tenancy	1.40	1.60	1.80	2.00	2.20	2.40	2.60	2.60
Rental/month (Rs)	35,000	34,000	33,000	32,000	31,000	30,000	29,000	29,000
Revenues (Rs '000)	588	653	713	768	818	864	905	905
EBITDA margin (%)	63.0	65.4	67.4	69.1	70.5	71.8	73.0	73.0
EBITDA (Rs '000)	370	427	480	530	577	621	660	660
Costs (Rs '000)	218	226	233	238	241	243	245	245
Incremental EBITDA margin (%)		87	89	91	93	95	97	97
Depreciation (Rs '000) - @8% of gross block	184	184	184	184	184	184	184	184
EBIT (Rs '000)	186	243	296	346	393	437	476	476
Interest expense (Rs '000) - @10%	115	115	115	115	115	115	115	115
PBT (Rs '000)	71	128	181	231	278	322	361	361
Tax expense (Rs '000) - @20%	14	26	36	46	56	64	72	72
PAT (Rs '000)	57	102	145	185	223	257	289	289
EV/EBITDA (X)	12.1	10.5	9.4	8.5	7.8	7.3	6.8	6.8
P/E (X)	58.6	32.8	23.1	18.1	15.0	13.0	11.6	11.6
ROIC (%)	7.5	9.4	11.3	13.1	14.7	16.2	17.6	17.6
ROE (%)	5.0	8.9	12.6	16.1	19.4	22.4	25.1	25.1

Source: Kotak Institutional Equities estimates

Exhibit 3: RCOM's condensed financial statements, March year ends, 2010-2017E

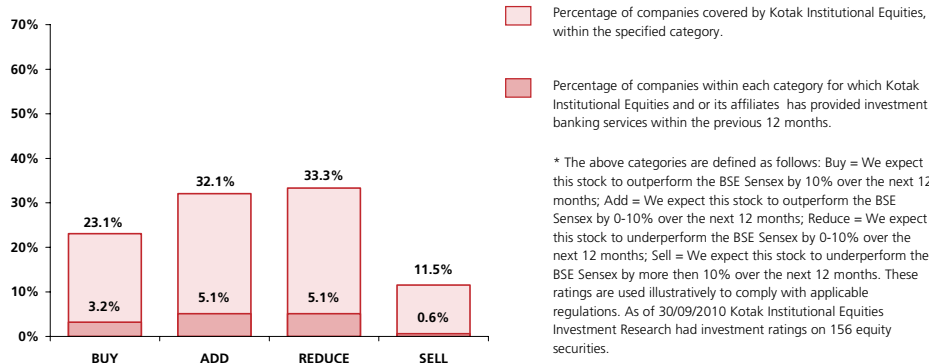
	2010	2011E	2012E	2013E	2014E	2015E	2016E	2017E
Profit model (Rs mn)								
Revenue	214,964	204,319	233,997	271,633	305,147	330,242	352,483	373,287
EBITDA	71,852	66,964	74,950	87,544	100,062	109,388	117,963	126,426
EBIT	34,387	26,418	30,009	40,327	50,658	58,026	64,721	71,365
Net interest income / (expense)	18,222	(10,860)	(11,325)	(12,925)	(13,372)	(12,748)	(10,273)	(9,534)
Tax	(4,454)	933	0	(1,370)	(2,983)	(4,528)	(6,534)	(8,656)
Net profit	42,445	14,641	16,834	24,182	32,454	38,899	46,064	51,325
Fully diluted EPS	19.7	6.9	7.9	11.3	15.2	18.2	21.6	24.1
Balance sheet (Rs mn)								
Cash	8,185	13,036	28,917	35,373	44,461	35,006	34,441	40,769
Other current assets	113,388	111,478	116,802	132,255	146,015	156,319	165,451	173,992
Fixed assets	712,539	807,007	809,453	814,074	812,384	808,378	803,398	796,935
Other current liabilities	187,351	176,671	161,637	172,136	178,990	185,084	190,757	195,988
Shareholders funds (incl. minorities)	440,190	456,681	475,365	501,397	535,700	576,450	624,364	677,538
Net (debt)/ cash	(288,969)	(334,118)	(338,238)	(321,781)	(292,694)	(252,148)	(202,713)	(146,385)
Free cash flow (Rs mn)								
EBITDA	71,852	66,964	74,950	87,544	100,062	109,388	117,963	126,426
Change in working capital	(7,642)	(8,771)	(20,358)	(4,954)	(6,906)	(4,210)	(3,459)	(3,310)
Cash tax (paid)	(3,725)	933	0	(1,370)	(2,983)	(4,528)	(6,534)	(8,656)
Capex on PP&E and intangibles	(41,621)	(135,014)	(47,386)	(51,839)	(47,713)	(47,356)	(48,263)	(48,597)
Free cash flow	29,422	(90,385)	(12,378)	7,828	20,293	34,161	45,352	54,072
Ratios (%)								
EBITDA margin	33.4	32.8	32.0	32.2	32.8	33.1	33.5	33.9
RoAE	9.9	3.3	3.7	5.1	6.4	7.2	7.9	8.1
ROAE (excl. cash and int. income)	8.5	2.5	2.0	3.6	5.2	6.6	7.7	8.3
RoACE	5.0	3.9	4.6	5.7	6.9	7.4	8.0	8.5
ROACE (excl. cash and int. income)	4.2	3.5	3.7	4.9	6.1	7.0	7.8	8.6
Net debt/EBITDA (X)	4.0	5.0	4.5	3.7	2.9	2.3	1.7	1.2
Net debt/equity (X)	0.7	0.7	0.7	0.6	0.5	0.4	0.3	0.2

Source: Company, Kotak Institutional Equities estimates

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Source: Kotak Institutional Equities

As of September 30, 2010

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