Telecommunication

The next round gets tougher

September 20, 2010

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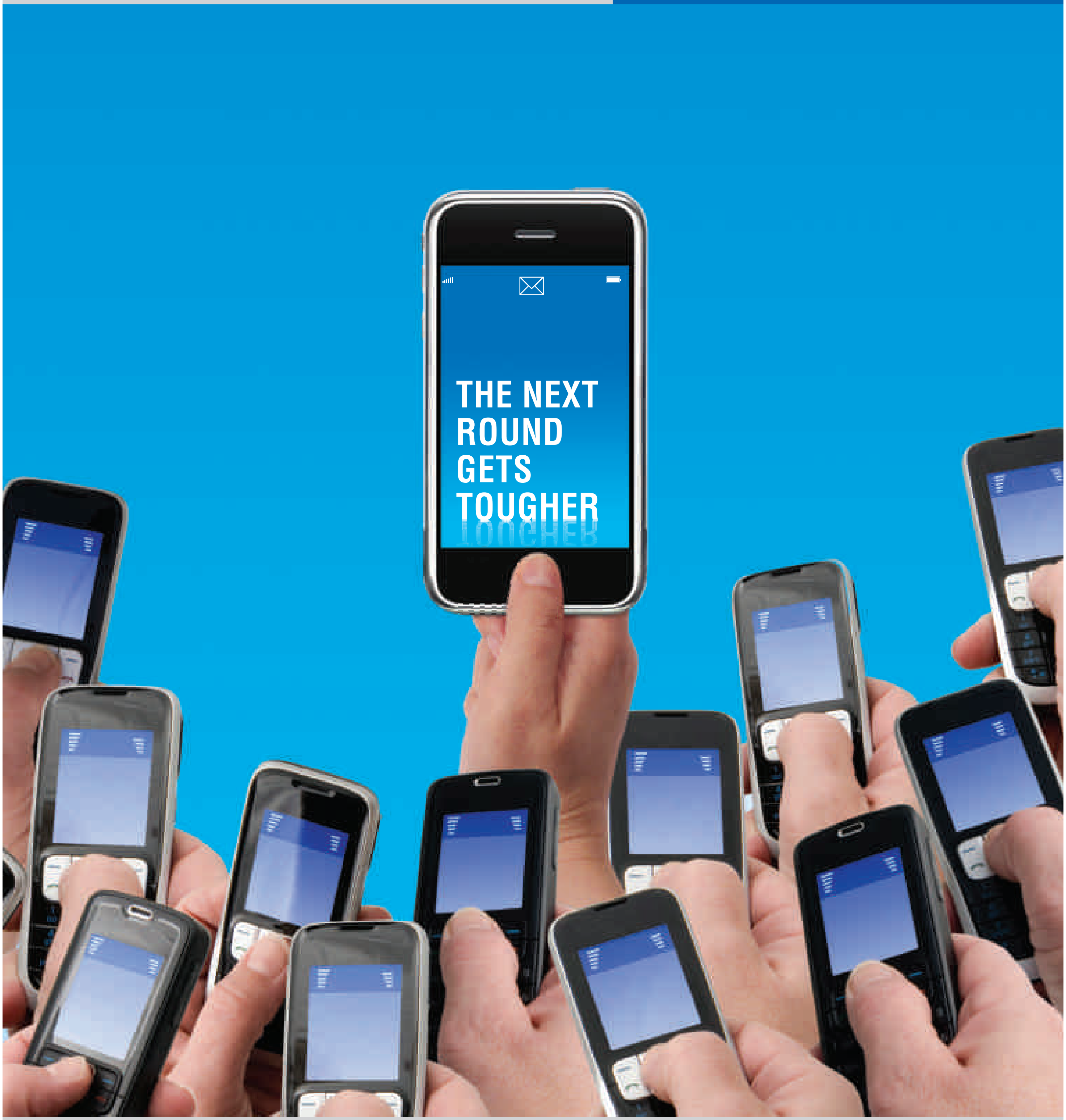

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Executive Summary

We maintain our medium-term cautious view on the telecom sector and downgrade Bharti Airtel (Bharti) to '**HOLD'** and Reliance Communications (Rcom) to **'REDUCE'**. We maintain **'HOLD'** on Idea Cellular (Idea) and **'BUY'** on Tulip Telecom (TTSL). We anticipate tariff wars to re-emerge with the implementation of Mobile Number Portability (MNP) and launch of 3G services. We believe, Bharti's dominance in revenue market share and margins will be challenged by Idea, Aircel, and Tata Docomo. The entry of MVNOs will further make the market competitive. Over the longer term, we believe, the sector will witness de-leveraging of balance sheets and sustenance of healthy cash flows. But, at current valuations the street is in for a disappointment.

- **Resurgence of competitive intensity likely**

  In the past 10 months, headline tariffs have been stable, but revenue per minute (RPM) has declined 22%. With implementation of MNP and launch of 3G services, we anticipate re-emergence of tariff wars. In our view, Idea, Aircel and Tata Docomo will utilise the MNP opportunity to target Bharti's and Vodafone's high usage customers. As per media reports, the government is planning to allow entry of MVNOs, which will make the market more competitive. Thus, Bharti's dominance, with 32% revenue market share will be severely challenged.

- **Margins to remain under pressure**

  MNP implementation and launch of 3G services will lead to escalation in costs. We believe, the entry of MVNOs will lead to further pressure on business for incumbents. While on one hand tariffs will be under pressure, on the other, we expect network operating costs and customer acquisition/retention costs to escalate. This, combined with expensing of interest cost and amortisation of 3G licence fee will lead to lower profitability. In our estimate, Bharti will have to generate incremental ARPU of INR 622 per month from 3G services in Mumbai to breakeven and INR 800 to defend current margins.

- **No meaningful consolidation expected**

  Street is expecting consolidation in the sector. We believe, a shake-out is imminent in the new operator segment. Post-consolidation we expect the current top 7 operators, who control 98% of industry revenues to continue. Thus, consolidation will not be meaningful.

- **Tower and handset businesses offer attractive alternate options**

  The tower industry is fairly consolidated with five players mostly fulfilling infrastructure requirements of telecom operators. We expect the tower industry to generate revenue of INR 191 bn and EBITDA of INR 112 bn in FY12E. The handset industry, riding on significant growth in subscribers, is expected to sell 295 mn handsets and report revenues of INR 286 bn in FY12E.

- **Valuations and view: Await a better entry point**

  Bharti and Idea stock price has risen 40% in the past three months due to investor optimism on stable tariff environment and as the stocks have under performed the broad indices over the past two years. We don't believe tariff wars have ended. Bharti is trading at similar valuations as it did when its stock price peaked in February 2008 despite higher competitive intensity in business and inferior financials. We downgrade Bharti to **'HOLD'** and RCOM to **'REDUCE'**. Maintain **'HOLD'** on Idea and **'BUY'** on Tulip Telecom.

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AT A GLANCE

					Financials (INR mn)				Growth (%)				Valuations				
Company	Price (INR)	Mkt cap (INR mn)	Reco		Revenue	EBITDA	Net profit	Annualised EPS (INR)	Revenue	EBITDA	Net profit	Annualised EPS	EV / EBITDA (x)	P/E (x)	P/B (x)	ROCE (%)	EBITDA margins (%)
Bharti Airtel	366	1,389,560	Hold	FY08	270,250	113,714	67,007	17.7	45.4	52.6	58.4	57.2	12.7	20.8	6.4	31.3	42.1
				FY09	369,612	151,677	84,698	22.3	36.8	33.4	26.4	26.4	9.7	16.4	4.6	29.6	41.0
				FY10	418,472	167,404	88,737	23.4	13.2	10.4	4.8	4.8	8.5	15.7	3.3	22.2	40.0
				FY11E	620,034	223,938	76,260	20.1	48.2	33.8	(14.1)	(14.0)	9.0	18.2	2.8	13.2	36.1
				FY12E	754,958	273,590	94,606	24.9	21.8	22.2	24.1	24.1	7.0	14.7	2.4	10.9	36.2
Idea	77	256,500	Hold	FY08	67,200	22,518	10,423	4.0	53.9	53.7	107.5	104.2	11.6	19.4	5.7	17.2	33.5
				FY09	101,258	28,359	9,015	2.9	50.7	25.9	(13.5)	(26.5)	10.4	26.4	1.8	9.6	28.0
				FY10	124,494	34,071	9,539	2.6	22.9	20.1	5.8	(9.3)	9.3	29.1	2.2	7.0	27.4
				FY11E	147,506	39,764	6,431	1.9	18.5	16.7	(32.6)	(27.1)	9.5	39.4	2.1	6.6	27.0
				FY12E	162,503	49,645	6,561	2.0	10.2	24.9	2.0	2.0	7.6	38.6	2.0	7.2	30.6
Rcom	175	373,275	Reduce	FY08	190,672	81,989	66,838	25.3	31.8	43.3	72.5	62.1	7.9	6.9	1.4	11.1	43.0
				FY09	229,416	92,877	59,079	27.7	20.3	13.3	(11.6)	9.5	7.0	6.3	0.9	7.7	40.5
				FY10	221,323	78,205	46,550	22.0	(3.5)	(15.8)	(21.2)	(20.7)	7.2	8.0	0.9	5.4	35.3
				FY11E	225,787	73,089	21,203	9.9	2.0	(6.5)	(54.5)	(54.8)	8.5	17.6	0.8	4.7	32.4
				FY12E	251,587	81,937	22,868	10.7	11.4	12.1	7.9	7.9	7.1	16.3	0.8	4.9	32.6
Tulip Telecom	172	24,911	Buy	FY08	12,163	2,455	1,870	11.5	44.7	83.3	97.7	76.7	11.4	14.9	5.6	23.1	20.2
				FY09	16,144	3,367	2,498	12.5	32.7	37.2	33.6	8.2	9.7	13.8	3.7	18.8	20.9
				FY10	19,664	5,255	2,743	16.1	21.8	56.1	9.8	29.1	6.4	10.7	2.7	19.7	26.7
				FY11E	22,703	6,366	3,061	18.9	15.5	21.1	11.6	17.2	5.3	9.1	2.2	22.1	28.0
				FY12E	25,621	7,245	3,419	21.1	12.9	13.8	11.7	11.7	4.6	8.2	1.8	23.0	28.3

Investment Rationale

■ Tariff wars set for a comeback in short term

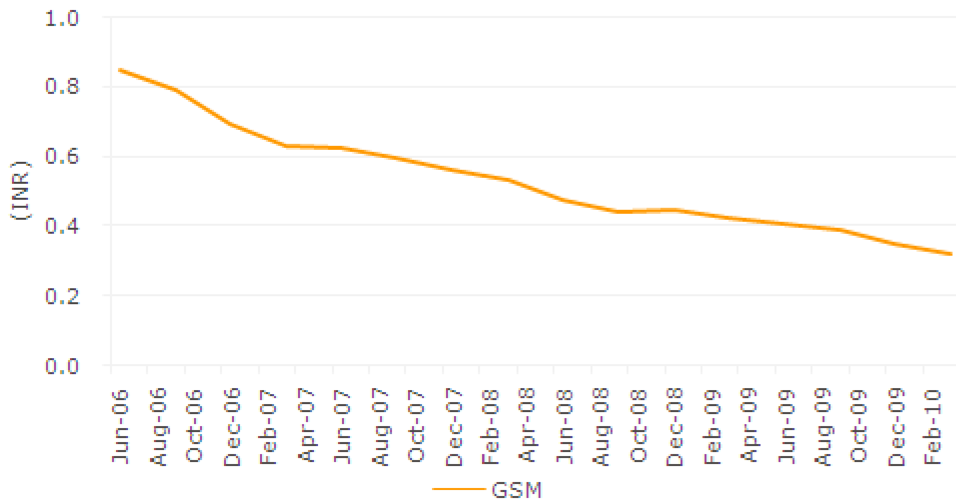
MNP, an opportunity for Idea, Aircel and Tata Docomo to grab revenue market share

MNP implementation and launch of 3G services will lead to enhanced competitive intensity. We believe, MNP will provide operators like Idea, Aircel, and Tata Docomo an opportunity to grab high usage customers from Bharti and Vodafone. While the street is arguing that operators will be rational in pricing 3G services, having paid significant licence fees, we believe, operators will be under pressure to build scale in these services and will likely price them attractively to achieve scale. Recent media reports indicate that the government is planning to allow the entry of MVNOs, which would lead to further price wars.

- **RPM decline even as headline tariffs remain stable**

Stability in tariffs over the past 10 months has led the market into believing that tariff wars are over. We agree that tariffs have reached unviable levels for a majority of the operators. But the street, in our view, is confusing between tariff and RPM. It is worth noting that Bharti's RPM declined 17% p.a. in the past three years, which included periods when tariffs remained stable. Promotions on various schemes in terms of free minutes at a circle level are typically always on offer. Hence, on a blended basis RPMs have trended downwards.

Chart 1: RPM declined continuously

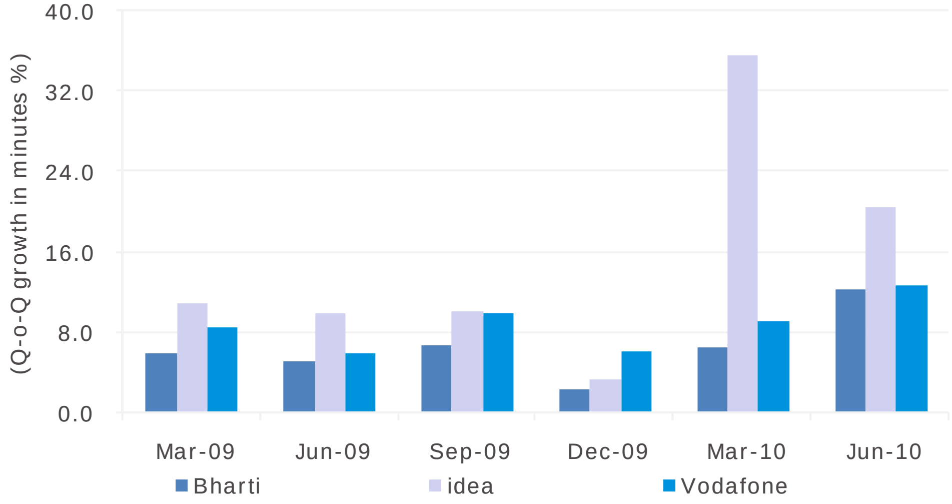


Source: TRAI

- **MNP will lead to competition among equals**

It is well established globally that incumbents rarely lose their leadership in the mobile market over a longer period of time due to the advantage of being an early entrant. Bharti, Vodafone, and Idea reported slower growth in minutes in H2CY10 as new operators launched services and started offering incentives to retailers linking them to subscriber market share. But GSM incumbents reported 8-11% Q-o-Q growth in total minutes in Q1FY11 as the free minutes offered by new operators expired and customers returned to their primary mobile operator.

Chart 2: Recovery in growth of minutes carried on network

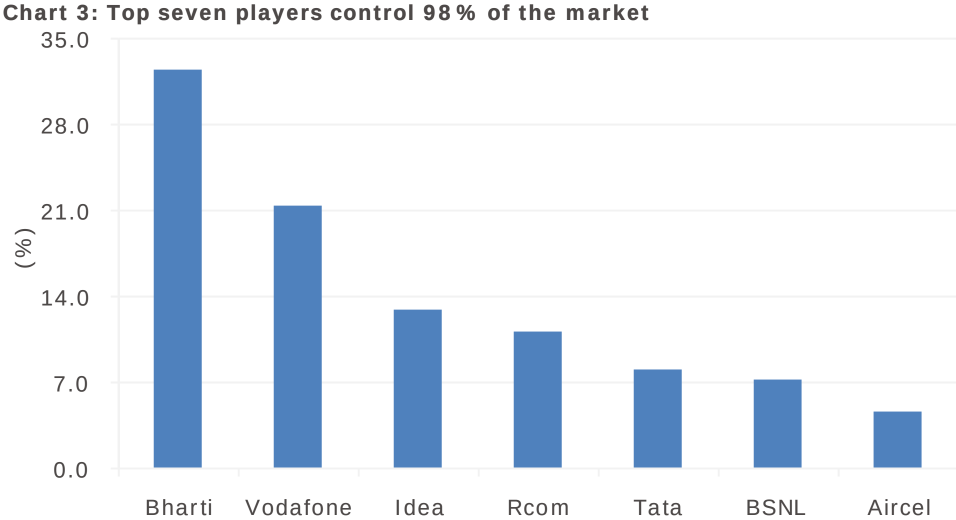


Source: Companies

M&A will churn out marginal players

Recent media reports indicate that competition, especially from new operators, is easing as current tariff levels have made operations unviable. Also, many of the new operators are established players in their home markets and perceive the challenges with respect to capturing market share from early entrants. Thus, the rate of cash burn by new operators has slowed down and most of them are focusing on RoI (Return on Investment). A few new operators are believed to have approached the government to surrender their licences on refund of licence fees. Also, media reports state that the government is planning relaxation of M&A norms, paving the way for consolidation. Thus, it seems that competition will ease due to consolidation in the sector. In our view, the industry is already consolidated with top seven players controlling 98% of the market (in revenue terms) and the top player, Bharti cornering 32% revenue market share. The presence of 14 operators in the market has only led to lack of pricing power for the large operators.

Chart 3: Top seven players control 98% of the market



Source: TRAI

Our analysis of the industry over a longer period of time indicates that the domestic mobile market will eventually have six-seven players including Bharti, Vodafone, Idea, BSNL, RCOM, Tata Docomo, and Aircel. Hence, the market will continue to remain competitive. It is worth noting that new operators have refrained from competing on price but focused on higher incentives to distributors and retailers to garner subscriber market share. The last round of tariff wars were re-initiated by the existing strong players with Tata Docomo introducing per second billing pricing and RCOM introducing its 'Simply Reliance' offer pricing all services at INR 0.5 per minute.

MNP is likely to be implemented in the near term. While past deadlines have been missed, the government has warned operators that they will be prevented from launching new services if they fail to become MNP compliant by September 2010. As incumbents have won 3G licences and have been allotted spectrum, the government warning will compel them to become MNP compliant, thereby paving the way for its implementation. The deadline set by the government for implementing MNP is October 31, 2010. In our view, MNP would be implemented before the launch of 3G services, which is expected by December 2010.

Few high-end users have dual-SIM phones

The street and incumbent operators believe that MNP will be a non event as it has been delayed and since customers already possess dual-SIM phones enabling the use of same handset for two numbers. It is expected that subscribers possessing a dual-SIM phone would be indifferent to MNP. MNCs, which formed nearly 80% of the handset market, didn't have a dual-SIM product in the market so far. Since a majority of the phones sold by domestic brands were dual-SIM enabled, we estimate that there are about 30 mn dual-SIM handsets in India, which, at 100% utilization, imply 60 mn SIMs or 10% of the total subscriber base who will be indifferent to MNP. A majority of Bharti's and Vodafone's customer base comprises high usage customers, who typically are not dual-SIM phone users. Hence, they will have the opportunity to switch operators without foregoing their numbers.

Table 1: Dual-SIM subscribers indifferent to MNP, but form a small proportion

Particulars	Nos.
Total no. of phones sold by Indian brands since January 2008 (mn)	30
Total no. of SIMs assuming all phones sold by Indian brands were dual-SIM (mn)	60
Total mobile subscriber base in India as of July 2010 (mn)	652
% of subscribers who would be indifferent to MNP as they have dual-SIM phones (mn)	9.0

Source: Media reports

Reliance Communications (RCOM) stated during its Q1FY11 results call that it will exploit the MNP and its 3G service opportunity in major circles to target high usage customers.

The 3G services will be launched in the next couple of quarters as soon as the spectrum is released and all equipment has been obtained. We are indeed privileged to be in the key circles of Delhi, Mumbai and Kolkata, and we have two benefits, one is that we are challengers in these circles as you said against the incumbents, and we are a new GSM player, therefore that plays to our advantage. With MNP coming in, there is even more opportunity for us to garner much higher revenue share in these circles. So, going forward we clearly see this as an advantage for us.

Mr. Syed Safawi, Head – Mobility, Reliance Communications

We expect some operators (Tata Docomo, RCOM, Idea, Aircel and BSNL) to utilise the MNP opportunity to lure the high usage customer base of incumbents especially, Bharti and Vodafone. It is interesting to note that Bharti has revenue market share of over 50% in Karnataka (the fifth largest circle) and about 40% or more in Andhra Pradesh (third largest circle in India), Delhi (second largest circle) and Bihar (10th largest). Vodafone has about 35% or more revenue market share in Gujarat (seventh largest circle in India), Mumbai (sixth largest circle in India) and Uttar Pradesh (W), which is the ninth largest circle in India.

Table 2: Bharti and Vodafone have high market share in top 10 circles

	Circle-wise revenues for Industry (INR bn)	Revenue market share (%)	
		Bharti	Vodafone
Tamil Nadu	**8.9**	**33.3**	**20.7**
Delhi	**8.5**	**37.4**	**23.9**
A. P.	**8.2**	**40.4**	**11.4**
Maharashtra	**7.5**	**20.8**	**21.5**
Karnataka	**7.3**	**50.5**	**14.5**
Mumbai	**6.9**	**20.2**	**33.4**
Gujarat	**5.7**	**20.9**	**41.0**
U. P. (E)	**5.3**	**34.1**	**20.0**
U. P. (W)	**5.2**	**15.4**	**36.9**
Bihar	**4.8**	**46.8**	**8.6**
Rajasthan	4.6	46.1	22.7
M. P.	4.4	30.7	4.6
Kerala	4.3	19.1	21.7
Punjab	4.0	37.2	17.0
West Bengal	3.0	29.1	37.0
Kolkata	2.6	28.6	30.8
Haryana	2.1	17.8	25.9
Orissa	2.0	39.3	8.1
Assam	1.6	33.8	8.2
J & K	1.1	39.3	5.1
North East	1.0	36.3	8.4
H. P.	0.7	43.2	6.1

Source: TRAI

- **Allowing MVNOs will lead to tariff wars**

MVNOs operate at low capital intensity and hence can compete on tariffs

The government seems to be taking cognizance of the new operators' inability to survive in the current competitive environment. Recent media reports indicate that the government is evaluating options to offer some reprieve to new operators including allowing them to surrender license and refund license fees, permitting the acquirer (in a M&A situation) to retain spectrum beyond the TRAI-recommended prescribed limit and leasing of spectrum to MVNOs. While the first two options will provide an exit to the new operators thereby reducing the number of operators, the last option would lead to entry of newer operators, who can operate with minimal capital requirements. Currently, Tata Teleservices is using the Virgin mobile brand to offer services to the youth segment. Virgin mobile offers INR 0.1 per minute on every call received. As MVNOs operate on a revenue share basis with the operators, whose network they offer services on, they have minimal capital requirements and offer a revenue stream for new operators who have under-utilised networks.

Margins to remain under pressure

MNP and 3G will lead to higher roll out and subscriber acquisition costs

Over the past six quarters, tariff wars and heightened cost of doing business have taken a toll on Bharti's and Idea's (excluding new circles) EBITDA margins—declined 400bps. As we expect tariff wars to re-emerge and competition to intensify in the medium term, we believe margins will remain under pressure. However, the street, due to stability in tariffs in the past 10 months, expects Bharti's margins to expand by about 200-250bps over FY10-12E.

But, in our view, margins will remain under pressure as:

- RPM will decline to INR 0.38 by FY12E from INR 0.45 in FY10 for the industry due to expected resurgence in tariff wars due to MNP and entry of MVNOs.
- Network operating expenses will rise as operators (especially those running at high capacity utilisation like Bharti, in our view) will have to pay additional rentals when they initiate 3G coverage.
- Customer retention / acquisition costs will rise due to MNP and 3G services launch.
- Interest cost and amortisation of license fees, which are currently being capitalised, will be expensed from the time 3G services are commercially launched.
- If TRAI recommendation that passive infrastructure companies be brought under the licence fee purview is adhered to, towercos claim that they will pass on the cost to tenants.

- **RPM to dip; inclusion of 3G services data revenues could skew numbers**

  Tariffs have remained stable for the past 10 months after Tata Docomo introduced per second billing and RCOM launched the 'Simply Reliance' plan, under which it offered a uniform rate of INR 0.5 on all local, SMS, and domestic long distance calls. But RPM declined from INR 0.54 in Q4FY09 to INR 0.44 in Q1FY11 for Bharti. As we expect tariff wars to reemerge due to MNP and 3G services, we believe RPM will trend downwards.

  But, it will be interesting to note that as 3G revenue share increases, the reported metric of RPM will trend upwards as data revenues are included in revenues but minutes of usage will only reflect the voice traffic. Thus, Bharti and Idea will report increase in RPM, but their margins could decline.

- **Network operating cost to rise on launch of 3G services**

  Incumbents with legacy network will incur higher network costs for 3G

  3G services are expected to be launched before January 2011 as spectrum has been allotted and operators have been creating the required infrastructure after conclusion of the auction. We thus expect network operating costs to rise in the course of launch of 3G services. We understand that for operators who have the latest equipment installed and have spare capacity, there is no additional cost of passive infrastructure. But operators which have legacy equipment and are operating at high utilisation will have to incur an additional cost for passive infrastructure. For instance, if Bharti has legacy systems in Delhi and is operating at high utilisation, then instead of replacing the legacy system which will enable it to provide both 2G as well as 3G services, it will install a new BTS for 3G and incur additional rental costs and other operating expenses.

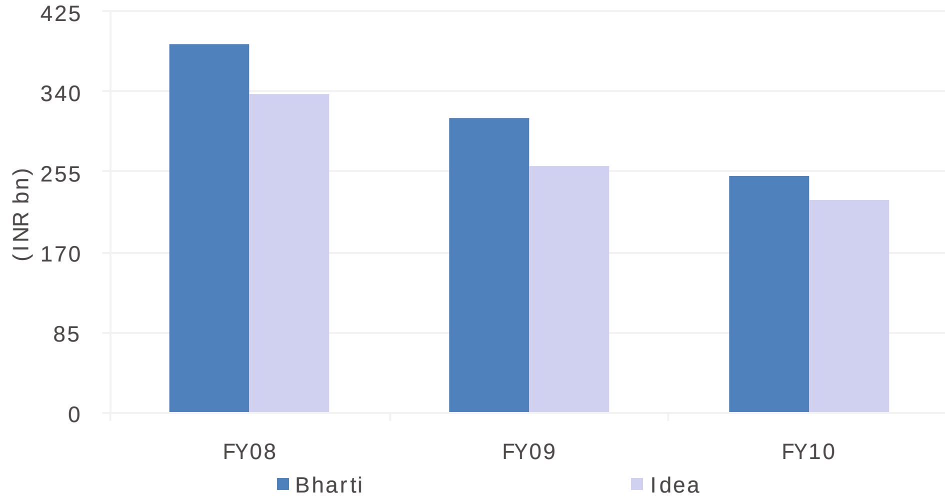
  Some operators including Aircel, Reliance GSM, Tata Docomo (GSM) and Idea (in newer circles) will not have to incur additional expenses. But incumbent operators like Bharti and Vodafone will be operating at high utilisation levels and hence will have to install a new BTS for 3G network and thus incur additional operating expenses. We believe, network created after 2006 would be 3G upgradable.

- **Customer acquisition/retention costs to rise**

Battle for subscribers post-MNP will increase sales and marketing costs

We expect MNP to be implemented before 3G services are launched. Thus, incumbent operators are likely to face intense competition to retain their existing high usage customers. Also, they are likely to poach high usage customers of their competitors, i.e., in Mumbai and Delhi we expect Bharti and Vodafone to target each other's high usage customers, while operators like Tata Docomo, Idea, RCOM and Aircel may target both Bharti and Vodafone customers in these two circles. In the process, we expect customer acquisition/retention costs to rise.

Chart 4: Subscriber acquisition cost (INR p.a.) will rise due to MNP and 3G



Source: Companies

- **Spectrum fee amortisation and interest costs to rise**

A majority of the INR 677 bn 3G licence fee paid by mobile operators has been funded through debt. The interest cost is currently being capitalised and is expected to be expensed on commercial launch of 3G services. Also, the license fee paid will be amortised from the time of commercial launch for 20 years. Our analysis suggests that the spectrum fee amortization and interest cost on debt taken for license fees alone will amount to ~INR 40/month/3G subscriber for Bharti and Idea and INR 81 for RCOM.

Table 3: 3G spectrum fee and interest cost calculation

	Bharti	Idea	RCOM
FY11 revenues (INR mn)	620,034	147,808	225,787
3G spectrum fee amortisation (INR mn)	6,148	2,884	4,293
Interest cost on debt related to 3G spectrum fees (INR mn)	7,377	3,461	5,151
Total incremental cost from spectrum fee and interest (INR mn)	13,525	6,345	9,444
As % of revenues	2.2	4.3	4.2
Current GSM subscriber base (mn)	139	70	49
Total 3G subscriber base assuming 20% upgrade to 3G (mn)	28	14	10
Minimum ARPU from 3G to cover interest cost and spectrum fee amortisation (INR)	40	38	81

Source: DoT, Companies

- **Risk of towercos passing on licence cost**

TRAI recently recommended that passive infrastructure service providers be brought under the licence regime. The regulator recommended that towercos, like mobile operators, should pay a share of revenues as licence fee. Based on our interaction with a few towercos, we believe, the increased cost will be passed on to tenants if this recommendation is implemented. This will put additional burden on operators, especially incumbent operators who have legacy equipment and are operating at high utilisation levels, like Bharti and Vodafone as they have to install additional BTS for 3G.

Table 4: Mobile operators' EBITDA margin to dip if towercos pass on licence fees

Particulars	
Total revenues of tower industry in FY12E (INR mn)	382,424
License fee @ 6% of revenues (INR mn)	22,945
Total revenues of mobile operators in FY12E (INR mn)	1,805,795
EBITDA margin impact (bps)	127

Source: Edelweiss research

Potential industry 'consolidation': Much ado about nothing

Top 7 operators with 98% revenue market share will remain post-consolidation

Recent media reports referred to potential consolidation in the telecom industry with some new operators reportedly considering exit options and the regulator actively working towards favorable industry M&A norms. These are being seen as early signs of consolidation and therefore return to rationalisation from a prolonged state of hyper-competitiveness. We, however, hold a contrary view as despite potential industry M&A/consolidation, we believe the market will continue to have atleast seven serious players (some with considerable support from their foreign partners) and considerable scale who will actively compete in the market. Even currently, the top 7 players control ~98% revenue and subscriber market share and, therefore, a shakeout in the bottom rung may not have a meaningful impact on the industry structure. We discuss this in further detail below.

- **Incumbents have largely fuelled hyper-tariff competition so far**

New operators have not waged tariff wars

Serious price competition in the Indian telecom market has primarily been driven by incumbent operators, in our view. Among the more defining tariff plans was the introduction of per second billing by Tata Docomo, followed by RCOM's *Simply Reliance* 50p (INR 0.5) plan. Just three of five new entrants have launched services so far (and largely on regional basis)—Uninor, Videocon, and STel. Only recently, Uninor introduced the *Dynamic Pricing Plan* while Videocon has introduced attractive packs for data usage. But again, the base voice tariff for these plans is not widely different from the industry average. New entrants have refrained from competing on tariff and have rather focused on incentivizing the sales channel for a higher subscriber market share.

- **Exit options likely on anvil for new entrants; may find few takers**

New operators will surrender spectrum/get acquired/lease spectrum to MVNOs

The regulator is supposedly actively working towards favorable industry M&A norms and other exit options for new entrants. Various options reportedly being considered include surrender of spectrum on refund of licence fee and possible relaxation of spectrum retention norms. For incumbents spectrum will be the only motive for acquiring a new entrant, that too in circles where they currently face severe spectrum crunch. Moreover, the need for additional spectrum is negligible in circles where they have recently acquired 3G spectrum. Recent media reports indicate that the government might consider allowing entry of MVNOs, who can lease spectrum from new entrants and offer services.

- **Market to remain competitive in presence of strong incumbents**

In the event of possible consolidation, we see seven serious players who are likely to continue in the Indian telecom market. These include incumbents with considerable scale and/or balance sheet strength and/or the backing of strong foreign partners or the Indian government (players highlighted in table 18; consider state-owned BSNL and MTNL as one player). These seven players control ~98% of revenue and subscriber market share and thus any shakeout in the bottom rung may not make a meaningful impact on industry competitiveness in our view. While we do not rule out the exit of some new players, even with a lower number of players, we reckon that surviving operators who have made considerable investments and set up substantial capacity will continue to actively compete and strive to achieve further scale and market share. Further, in the near term competition is like to intensify again with the introduction of MNP and launch of 3G services.

Table 5: All serious players have won 3G license

Operators	Mn subs	Subs market share (%)	Gross revenue (INR bn)	Revenue market share (%)	3G investment (INR bn)	Strategic partner
Bharti Airtel	131	21.0	350	32.2	123	Singtel
Reliance Communications	104	16.7	126	11.6	86	NA
Vodafone Essar	101	16.2	222	20.4	116	Vodafone
BSNL	97	15.7	97	9.0	102	Government
Idea Cellular	64	10.3	133	12.2	58	Axiata
Tata Teleservices	67	10.8	80	7.3	59	NTT Docomo
Aircel	37	5.9	41	3.8	65	Maxis
MTNL	9	1.4	7	0.7	65	Government
Uninor	4	0.7	9	0.8		Telenor
Sistema Shyam	4	0.6	2	0.2		Sistema
BPL	3	0.5	5	0.5		NA
Stel	1	0.2	0	0.0	3	Bahrain Tel
HFCL	1	0.1	1	0.1		NA
Videocon	0	0.0	0	0.0		NA
Etisalat DB	0	0.0	13	1.2		Etisalat
Total	**621**		**1,086**		**676**	

Source: DOT, TRAI, Companies

Even among new entrants, a few operators have strong strategic partners with deep pockets and considerable balance sheet strength who could therefore continue to compete in the market.

Table 6: Summary of operators and their foreign partners in India **(USD mn)**

Foreign player	Operator	Revenue	EBITDA	Net profit	Total debt	Net debt	Operating cash flow
Singtel	Bharti	11,829	2,899	2,740	4,755	3,481	3,540
Vodafone	Vodafone	71,001	23,660	13,802	60,567	59,435	21,130
NTT Docomo	Tata	46,202	16,557	5,336	6,887	1,375	12,730
Axiata	Idea	3,723	1,534	469	3,353	1,876	1,374
Maxis	Aircel	2,162	494	448	1,526	1,245	354
Bahrain Telecom	Stel	920	399	279	0	(119)	430
Telenor	Uninor	15,610	5,365	1,383	6,408	4,155	4,985
Etisalat	Swan Telecom	8,394	2,904	2,406	1,472	(1,571)	2,757

Source: Bloomberg

Our meetings with some of the new operators indicate that a few of them have even chalked out aggressive expansion plans and seem to be serious players.

Table 7: New operators' plans

	Uninor	MTS	Videocon	Aircel
Current subscriber	6,873,798	5,582,683	2,777,396	43,296,659
No. of cell sites	20,000	8,000	25,000	50,000
Points of presence	300,000-350,000			
Tower partner	Quippo			
Total investment so far	USD 1,300 mn	USD 1,500 mn		USD 2,000 mn in CY09 and USD 4,000 mn so far
FY11 capex	USD 650 mn			
Total investment expected	INR 150bn		INR 150 bn and targeting 100 mn subscriber base in 3 years	USD 3,000 mn over next 3 years
EBITDA breakeven in	2013	2013		
Cash breakeven	2015			
Near-term tariff expectation	Tariffs could go down further by 10-15% in the next few months	Focusing on ROI and have capped investments. Seeking 'profitable customers'	Not a low ARPU player and not advertising low tariffs. Will launch some attractive post paid schemes targeting incumbents	Will not initiate price war and tariff levels are unsustainable. Tariffs would have mostly bottomed out
Views on:				
Data business	Not a cornerstone of company strategy. Focused primarily on voice	Currently, 15-20% of revenues. Focus is on data business	Not very bullish on data business. Focused on voice	Data grew from 5% of revenues in Dec 2008 to 11% currently. Parent, Maxis, generates 35% from data in its home country and is targeting 50%. Hence, bid aggressively for 3G and broadband
Handset bundling			Sold 300,000 handsets in May. Will offer bundled deals	
MNP	An opportunity for new players	Not a big opportunity	Strategy is not to wait for churn till MNP is implemented, instead be proactive and offer strong value proposition to existing high usage customers of incumbents	
M&A	Transaction fee is very high and returning spectrum over the prescribed limit not conducive. If these norms are relaxed then is willing to participate in M&A	Never say no, but instead could partner with another GSM player for voice and bundle it with a dual SIM handset		Aircel is a dominant player, hence though partners may change, company will remain. Would be on either side of M&A depending on the opportunity and valuations

Source: Edelweiss research

3G services: Margin dilutive

Domestic telecom operators cumulatively shelled out ~USD 15 bn for 3G spectrum in May 2010. While no operator won a pan-India licence, various operators were able to win licences in a combination of circles with adequate revenue and subscriber coverage (69-90%). Bharti bid the highest amount (~INR 123 bn) followed by Vodafone (~INR 116 bn) and BSNL (~INR 102 bn). Among incumbents, Idea seemed to be the most focused with subscriber/revenue coverage of 81/82%, followed by BHARTI (65%/68%) and Vodafone (61%/69%). RCOM subscriber/revenue coverage was even lower at 49%/55% though it won licences in key circles of Mumbai and Delhi.

Table 8: 3G licence winners

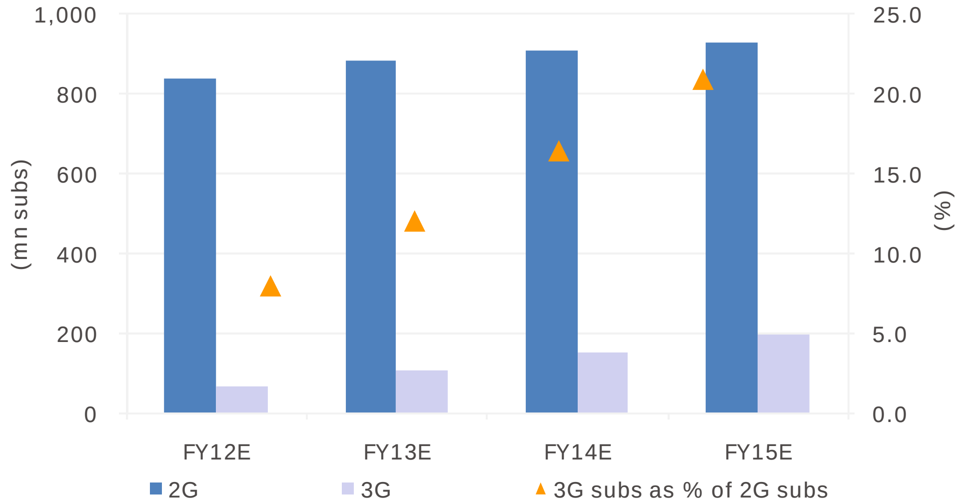
Operator	Bharti Airtel	Idea Cellular	Reliance Telecom	Vodafone Essar	BSNL	Tata Tele-services	Aircel	S Tel Private	MTNL	Total
3G licence fee (INR mn)	122,955	57,686	85,850	116,179	101,866	58,643	64,995	3,377	65,640	677,190
Subscriber coverage (%)	65	82	49	61	100	48	89	43	100	
Revenue coverage (%)	68	81	55	69	100	44	94	100	100	
3G licence fee (INR mn)										
Metros										
Delhi	33,169	-	33,169	33,169	-	-	-	-	33,169	132,677
Mumbai	32,471	-	32,471	32,471	-	-	-	-	32,471	129,883
Kolkata	-	-	5,443	5,443	5,443	-	5,443	-	0	21,770
Category A										
Maharashtra	-	12,578	-	12,578	12,578	12,578	-	-	-	50,313
Gujarat	-	10,761	-	10,761	10,761	10,761	-	-	-	43,042
Andhra Pradesh	13,731	13,731	-	-	13,731	-	13,731	-	-	54,926
Karnataka	15,799	-	-	-	15,799	15,799	15,799	-	-	63,196
Tamil Nadu	14,649	-	-	14,649	14,649	-	14,649	-	-	58,598
Category B										
Kerala	-	3,125	-	-	3,125	3,125	3,125	-	-	12,499
Punjab	-	3,220	3,220	-	3,220	3,220	3,220	-	-	16,101
Haryana	-	2,226	-	2,226	2,226	2,226	-	-	-	8,903
UP (E)	-	3,646	-	3,646	3,646	-	3,646	-	-	14,583
UP (W)	5,140	5,140	-	-	5,140	5,140	-	-	-	20,562
Rajasthan	3,210	-	3,210	-	3,210	3,210	-	-	-	12,841
MP	-	2,584	2,584	-	2,584	2,584	-	-	-	10,334
WB	1,236	-	1,236	1,236	1,236	-	1,236	-	-	6,182
Category C										
HP	372	372	372	-	372	-	-	372	-	1,862
Bihar	2,035	-	2,035	-	2,035	-	2,035	2,035	-	10,173
Orissa	-	-	970	-	970	-	970	970	-	3,879
Assam	415	-	415	-	415	-	415	-	-	1,659
North East	423	-	423	-	423	-	423	-	-	1,692
J&K	303	303	303	-	303	-	303	-	-	1,515

Source: DOT, TRAI

- **FY15E 3G subscribers at 194 mn; to comprise 21% of subscriber base**

  3G licence winners were allotted spectrum in September 2010. We expect operators to roll out 3G networks in a phased manner (starting with key circles of metros and Category A) and launch 3G services by early Q4FY11. Assuming minimal 3G penetration in FY11, we estimate country 3G subscribers at ~67 mn in FY12 and estimate them to post a 42.7% CAGR over FY12-15E to ~194 mn. India's 3G subscriber model incorporates a phased circle-wise 3G penetration over FY12-15 with FY12 penetration at 50% for metros and Category A circles followed by Category B circles at 25% and Category C circles at 10-25%.

Chart 5: 3G subscriber forecasts



Source: Edelweiss research

3G operators have to strike a balance between affordability and scale

- **Massive licence fee outgo and low pricing power to impact profitability**

  Our analysis suggests a materially high breakeven incremental ARPU from 3G services across service operators, ranging between 0.25x and 4x+ current 2G ARPU. We reckon this is primarily on account of high licence fee amortisation and financing costs (owing to high entry fee) besides operator-specific attributes like low subscriber base in key circles leading to higher costs on a per subscriber basis.

  As an illustration we discuss the threshold incremental ARPU for Bharti and RCOM, both won licences in Delhi and that for Bharti and Idea for the AP circle. For Delhi, at 20% 3G penetration, we estimate FY12 3G subscriber base for Bharti at 1.5 mn while that for RCOM at 0.7 mn. Consequently, despite the same licence fee outgo, amortisation, finance cost and broadly similar cost structure, breakeven incremental ARPU for the former works out to INR 283 while that for the latter will be INR 538. Likewise, for Andhra Pradesh, at FY12 3G subscriber base of 3.6 mn for Bharti and 1.7 mn for Idea, we arrive at threshold incremental ARPU of INR 70 for the former and INR 123 for the latter. It is important to note that Bharti would require to generate an incremental ARPU of INR 622 in Mumbai from its 3G subscriber to breakeven. It generates an ARPU of INR 431 currently in Mumbai.

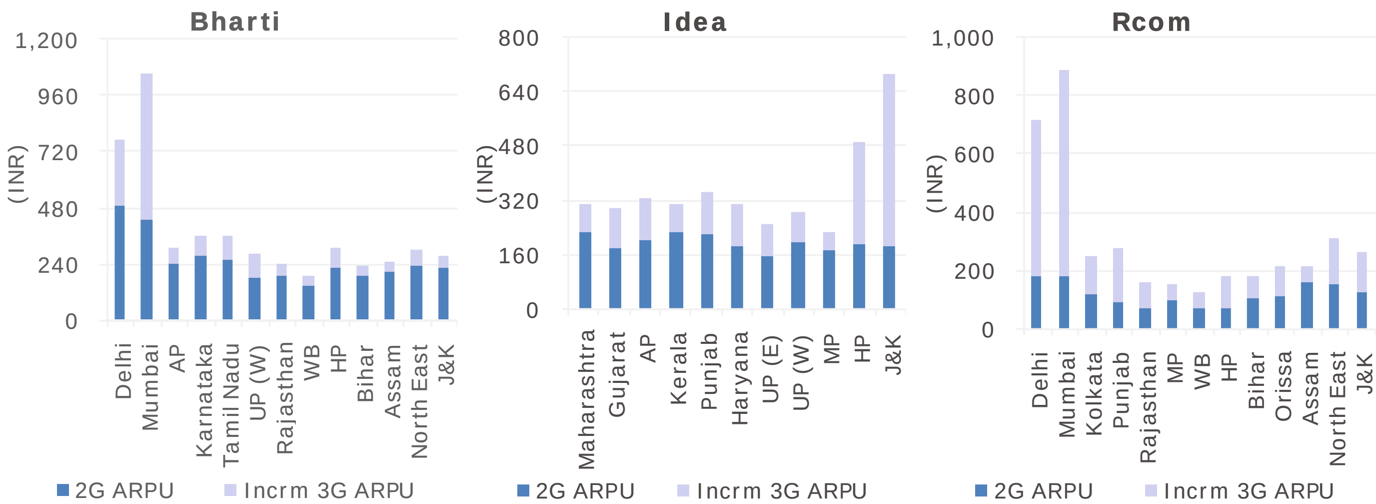
Table 9: Bharti—Required 3G ARPU to break-even

Service Area	Licence fee (INR mn)	FY12E subs (mn)	FY12E 3G subs (mn)	(INR/subscriber/month) Licence fee revenue share	Spectrum charge	Access charge	Cost p.m. per sub	Break even incrm 3G ARPU
Delhi	33,169	7.6	1.5	28	17	17	221	283
Mumbai	32,471	3.2	0.6	62	37	37	486	622
Andhra Pradesh	13,731	18.2	3.6	7	4	4	55	70
Karnataka	15,799	14.8	3.0	9	5	5	69	88
Tamil Nadu	14,649	11.4	2.3	10	6	6	79	101
UP (W)	5,140	7.3	0.7	8	4	6	85	103
Rajasthan	3,210	14.7	1.5	4	2	3	40	49
WB	1,236	10.4	0.7	3	2	3	36	43
HP	372	1.4	0.1	5	3	5	69	82
Bihar	2,035	20.0	1.0	3	3	3	39	47
Assam	415	4.3	0.2	3	2	3	38	45
North East	423	2.0	0.1	4	3	4	59	70
J&K	303	3.4	0.1	3	2	3	47	56

Source: DOT, Edelweiss research

We believe the twin hurdles of high threshold breakeven ARPU coupled with low 3G subscriber base in certain circles could drive operators to target higher volume growth by pricing services attractively versus focusing only on high-ARPU quality subscribers. Thus, we believe, atleast initially, operators may target speedy 3G penetration and improve capacity utilisation by pricing 3G services at affordable rates vis-à-vis facing the risk of running under-utilized networks if priced as a premium service.

Chart 6: Circle-wise indicative total ARPU post 3G launch (current 2G ARPU plus 3G break-even ARPU)



Source: TRAI, Edelweiss research

Introduction of MNP will further create challenges for operators, as they are likely to face higher churn rates should they price services at a premium versus competition (with relatively lower market shares) whose key endeavor will be to grab maximum subscriber market share at the cost of short term potential dent in profitability. Overall, we believe 3G is likely to turn out to be margin dilutive for operators who are likely to face dual challenges of low pricing power (for 2G and 3G services) in an intensely competitive market and a higher cost structure arising from licence fee amortisation, financing and subscriber acquisition costs.

BWA auction

In June 2010, the government collected ~INR 385 bn (~USD 8.6 bn) from the auction of BWA licences. Infotel (owned by Reliance Industries) emerged as the sole pan-India BWA operator and paid INR 128.5 bn for the licence. Of the two slots available per circle for private operators, the second slot was taken by five different operators —Aircel (8 circles), Tikona Digital Networks (5 circles), Qualcomm (4 circles), Bharti (4 circles), and Augere (1 circle). Bharti won in four circles (Kolkata, Maharashtra, Karnataka and Punjab) of which in three (Kolkata, Maharashtra and Punjab) it does not have a 3G licence. Aircel emerged as the surprise packet in the BWA auction, winning licences in eight circles. These circles overlap with circles in which it already has a 3G licence.

In July 2010, the government allotted BWA spectrum to all licence winners (excluding Qualcomm and Augere who were yet to fulfill the FIPB norms and other regulatory requirements then) but we believe that the launch of BWA services is atleast a 12-18 months away based on operator statements/media reports.

Table 10: BWA licence winners

Operator	Promoter/JV partner	No. of circles	Licence fee paid (INR bn)	Stated technology
Infotel Broadband	Reliance Industries (95% stake), HFCL (5%)	22	128.5	Most likely TD-LTE
Qualcomm Inc	Qualcomm (74% stake), Tulip Telecom (13%), Global Holdings (13%)	4	49.1	TD-LTE
Bharti Airtel	Bharti Airtel	4	33.1	WiMAX/TD-LTE
Aircel	Aircel	8	34.4	WiMAX/TD-LTE
Tikona Digital Networks	Founded by Prakash Bajpai (formerly at Rcom)	5	10.6	Most likely TD-LTE
Augere (Mauritius)	Founded by Sanjiv Ahuja (former CEO of Orange)	1	1.2	Most likely WiMAX

Source: DOT, Media reports

Table 11: BWA winners (INR mn)

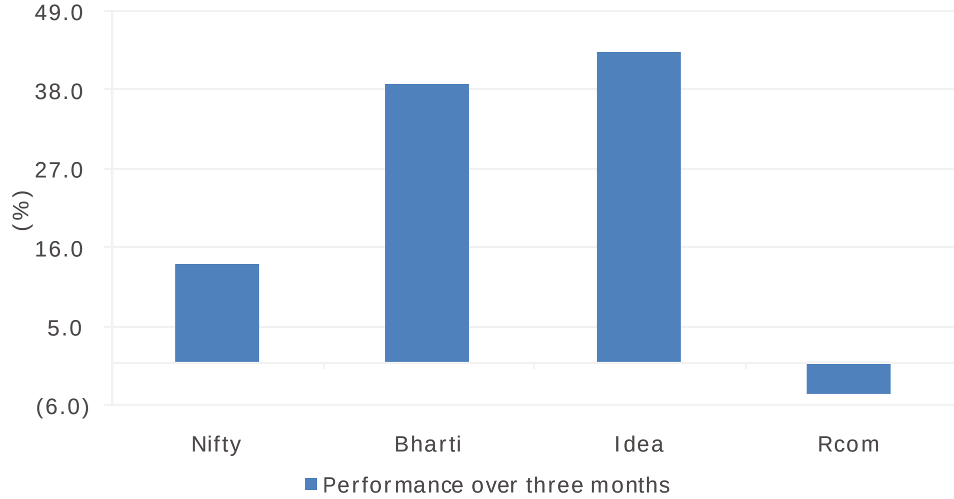
Service area	3G spectrum price (INR mn)	BWA spectrum price (INR mn)	BWA licence winners: Infotel Broadband	Qualcomm	Bharti Airtel	Aircel	Tikona Digital Networks	Augere
Metro	**71,083**	**50,572**						
Delhi	33,169	22,410	22,410	22,410				
Mumbai	32,471	22,930	22,930	22,930				
Kolkata	5,443	5,232	5,232		5,232			
Category A	**67,519**	**62,013**						
Maharashtra	12,578	9,156	9,156		9,156			
Gujarat	10,761	6,139	6,139				6,139	
Andhra Pradesh	13,731	10,591	10,591			10,591		
Karnataka	15,799	15,433	15,433		15,433			
Tamil Nadu	14,649	20,695	20,695			20,695		
Category B	**24,387**	**13,302**						
Kerala	3,125	2,587	2,587	2,587				
Punjab	3,220	3,323	3,323		3,323			
Haryana	2,226	1,199	1,199	1,199				
UP (E)	3,646	1,425	1,425				1,425	
UP (W)	5,140	1,839	1,839				1,839	
Rajasthan	3,210	973	973				973	
MP	2,584	1,247	1,247					1,247
WB	1,236	710	710			710		
Category C	**4,518**	**2,591**						
HP	372	207	207				207	
Bihar	2,035	993	993			993		
Orissa	970	636	636			636		
Assam	415	330	330			330		
North East	423	213	213			213		
J&K	303	213	213			213		
Total (INR mn)	**167,506**	**128,478**	**128,478**	**49,125**	**33,144**	**34,380**	**10,582**	**1,247**

Source: DOT

Valuations: Await a better entry point

Telecom stocks Bharti and Idea after underperforming for about two years have evinced renewed investor interest. Bharti and Idea have jumped ~40% in the past three months, outperforming the Nifty Index, which has risen 14%. The street believes that tariff wars are over as tariffs have remained stable in the past 10 months. Also, it expects Bharti and Idea to regain revenue market shares and improve margins.

Chart 7: Stock performance over three months



Source: Bloomberg

Bharti trading at marginal discount to levels when its stock price peaked in February 2008

- **Bharti trading at premium valuation; downgrade to 'HOLD'**

We expect tariff wars to reemerge and cost pressures to increase. It is interesting to compare street expectations from Bharti on various parameters in February 2008, when the stock hit its historic peak and now. We note that Bharti is trading at a marginal discount currently compared to its peak, even though expected organic growth, margins, ROCE are lower and quality of balance sheet is relatively inferior. Also, debt hardly contributed to EV in February 2008, but currently constitutes 31% of EV. Even as, the two-year underperformance is being cited as enough reason to buy the stock we believe valuations at current levels leave little room for disappointment. While we do not have the consensus data on FCF, in September 2008 the street was expecting Bharti to generate FCF FY09 onwards. We agree that the stock will generate strong FCF FY12 onwards, but current valuations are discounting that adequately.

Table 12: Bharti—Comparison of financials and valuation (current and at peak)

Particulars	Q4FY08	Q1FY11
Price (INR)	468	355
Market cap (INR mn)	1,774,537	1,347,509
No. of shares (mn)	3,796	3,796
Net debt (INR mn)	41,562	602,308
EV (INR mn)	1,816,099	1,949,817
Market cap/EV (x)	0.98	0.69
EBITDA (INR)	35,221	43,907
Shareholders equity (INR mn)	238,329	435,037
Susbcriber market share (%)	24.51	21.70
Revenue market share (%)	32.66	32.45
Top 3 competitors' combined revenue market share (%)	45.12	45.59
ARPU (INR)	357	215
MOU	507	480
Minutes (mn)	89,058	197,718
RPM (INR)	0.72	0.45
EBITDA per minute (INR)	0.26	0.17
Operating PBT margin (%)	25.4	16.9
ROCE (%)	33.8	18.7
Net debt/EBITDA (x)	0.30	3.43
Net debt/Equity (x)	0.17	1.38
Expected 2-year CAGR in revenues (%)	18.6	18.9
Expected EBITDA margin rise / (decline) over next two years	+400 bps	+260 bps
Expected 2-year CAGR in EBITDA (%)	30.1	25.8
2-year forward EV/EBITDA (x)	9.4	7.4
2-year forward P/E (x)	16.9	14.2

Source: Bloomberg, Edelweiss research

Bharti fair value based on DCF of INR 387

Our fair value for Bharti, as per DCF analysis, is INR 387 assuming a terminal growth of 4%. We expect over USD 2 bn FCF p.a. for Bharti over the next four years and hence terminal value constitutes 67% of overall EV. While the street is considering sum-of–the-parts valuation by valuing its tower assets separately, we do not see Bharti being able to exit Indus Towers or Bharti Infratel entirely. Thus, we are using consolidated cash flows for Bharti including Bharti Infratel and Indus Towers (as Bharti currently reports) in our DCF model and arrive at a fair value of INR 387. At the current price, we downgrade the stock to **'HOLD/Sector Outperformer'** from **'BUY'** as we believe the expected medium-term pressure on business will disappoint the street.

We note that Bharti's EV when its stock price peaked (February 05, 2008) was INR 1.8 tn whereas its current EV is INR 1.9 tn i.e., it has risen a mere 3% compounded p.a.

Table 13: Bharti's EV has risen a mere 3%

	Feb-08	Sep-10	*CAGR (%)*
Price (INR)	468	355	*(10.5)*
No. of shares (mn)	3,796	3,796	
Market cap)INR mn)	1,776,434	1,347,509	*(10.5)*
Net debt (INR mn)	41,562	602,591	*191.4*
EV (INR mn)	1,817,996	1,950,100	*2.8*

Source: Bloomberg, Edelweiss research

We expect Bharti to deleverage and reduce net debt from INR 653 bn in Q1FY11 to INR 93 bn by FY15E, If its EV remains stable at INR 2 tn then (as it has since February 2008), its market cap would rise from INR 1.4tn to INR 1.9tn by FY14, which would imply an 10% compounded annual return.

Table 14: Stock returns in various years assuming current EV stays

Current EV (INR mn)	1,950,100
Net debt (INR mn)	602,591
Market cap (INR mn)	1,347,509
FY12 EBITDA (INR mn)	273,590
FY12 EV/EBITDA (x)	7.1
FY12 EV (same as current EV)	1,950,100
Estimated net debt in FY12 (INR mn)	524,116
Market cap in FY12 (INR mn)	1,425,984
2-year CAGR in market cap (%)	**3.8**
FY13 EBITDA (INR mn)	333,164
FY13 EV/EBITDA (x)	5.9
FY13 EV (same as current EV)	1,950,100
Estimated net debt in FY13 (INR mn)	284,631
Market cap in FY13 (INR mn)	1,665,469
3-year CAGR in market cap (%)	**8.8**
FY14 EBITDA (INR mn)	383,693
FY14 EV/EBITDA (x)	5.1
FY14 EV (same as current EV)	1,950,100
Estimated net debt in FY14 (INR mn)	58,790
Market cap in FY14 (INR mn)	1,891,310
4-year CAGR in market cap (%)	**10.2**
FY15 EBITDA (INR mn)	429,100
FY15 EV/EBITDA (x)	4.5

Source: Edelweiss research

- **Idea's strong brand to enable market share gains, maintain 'HOLD'**

Idea deserves to trade at a premium due to stronger improvement in metrics

Idea, in our view, has been gaining market share as it has reported faster growth in minutes compared to its larger peers Bharti and Vodafone. Also, Idea is now the third largest operator in India by revenues with a market share of 13%. The company's margins are likely to rise over the next couple of years as its operations in new circles turnaround and achieve stable state margins. But, the stock is trading at 10% premium to Bharti on EV/EBITDA (x) basis. Idea has traditionally been viewed as an M&A play with the street expecting its current shareholders to sell out. Given its size (third largest in terms of revenue), we believe, any foreign partner who would evaluate entry into India at this juncture will consider acquiring Idea. Thus, the stock will continue to trade at a premium to Bharti. We maintain our **'HOLD'** and rate it as a **'Sector performer'**.

- **RCOM following a defensive strategy; downgrade to 'REDUCE'**

RCOM could lose out due to lack of 3G presence in key circles

RCOM, we believe, has followed a defensive strategy while bidding for 3G license. In our view, given its lower market share of about 11% and its intent to use MNP opportunity to target high-end customers, it should have focused on the more lucrative circles in Category A, where it has low revenue market share. But instead, it focused on winning 3G license in circles where it currently has higher revenue market share, which are the Category C circles. Thus, we believe, it focused on defending its existing revenue base rather than aiming to increase market share in the more lucrative circles. For RCOM, we believe, de-leveraging is a necessity and recent news flow (deal with GTL Infra cancelled and strategic investor denying in the media of an imminent stake buyout) on that aspect has been disappointing. RCOM is trading at 7.1x FY12E EV/EBITDA and the trigger for the stock would be improvement in metrics. We downgrade the stock to **'REDUCE/Sector Underperformer'** from **'HOLD'.**

Tower business: An attractive alternative

The passive infrastructure services business has gained significant scale due to the unrelenting strong growth in subscriber base and consolidation in the sector. The 5% divestment to private equity investors by RCOM in Reliance Infratel and setting up of Indus Towers by Bharti, Vodafone, and Idea brought the value locked in the operators' passive infrastructure into the limelight. Indus Towers is the largest player with 103,000 towers. We estimate there are about 530,000 BTS installed in India.

Table 15: Major tower companies in India

Towercos	Anchor tenants	Total no. of towers
Indus	Bharti, Vodafone and Idea	102,938
Reliance Infratel	RCOM	50,000
BSNL	BSNL	50,000
Viom	Tata Docomo	38,000
Bharti Infratel	Bharti	30,568
GTL Infra	Aircel	30,000
Others		15,000
Idea Infratel	Idea and Vodafone	8,719
MTNL	MTNL	2,500
Total		**327,725**

Source: Companies, Edelweiss research

3G to bring in additional revenues, not significant tenancy

Operators like Bharti and Vodafone, with legacy equipment and operating at optimum utilisation on 2G network, will have to install new BTS for 3G. While the street is expecting tenancy to rise due to 3G, we are given to understand that as most of the towercos are 'controlled' by operators, they will earn minimal rental on additional tenancy. For operators like Idea, Aircel, Tata Docomo and RCOM, who we believe have latest equipment and are operating at lower utilisation, will require a software upgrade and hence will not incur any additional rental fee for passive infrastructure services. Thus, in our forecast, we are assuming minimal incremental tenancy from 3G as we believe towercos will not see an uptick in tenancy, but we are assuming INR 3,000 per month as rental fee from operators who have legacy equipment. But BWA would prove to be an incremental opportunity for the sector. We expect EBITDA of INR 111 bn for the tower industry in India by FY12 and at 13x EV/EBITDA (at a marginal discount to American Towers), the sector will have an EV of INR 1.5 tn (USD 31 bn).

Table 16: Tower industry forecasts

	FY10	FY11E	FY12E	FY13E	FY14E	FY15E
Total industry BTSs	533,699	664,884	746,112	792,164	821,447	842,128
Total no. of towers	327,725	379,934	414,507	428,197	432,341	443,225
Tenancy (x)	1.6	1.8	1.8	1.9	1.9	1.9
Total rental revenues (INR mn)	138,875	169,717	191,212	202,174	208,725	213,760
Blended rental rev. per tower per month (INR)	21,684	21,272	21,356	21,268	21,175	21,153
EBITDA margin on 2G (%)	52.0	55.0	58.0	61.0	63.0	65.0
Total EBITDA (INR mn)	72,215	93,344	111,585	124,355	132,557	140,145

Source: Edelweiss research

Thus, investors seeking alternate investment options to play the India telecom growth story could look at investing in the passive infrastructure companies. Indus towers is the largest towerco in India with ~103,000 towers but is operating at a tenancy of 1.7 and EBITDA margin of 36%. Viom (erstwhile Quippo), which counts Tata Docomo as its anchor tenant, seems to be operating at highest tenancy of 2.2 in the sector and is also the most profitable with 52% EBITDA margins.

Handset business: Pressing the right buttons

Handset industry to witness 30% CAGR in volumes over FY10-13E

Rapid growth in the mobile services market and presence of high quality and scale companies like Bharti and Idea had overshadowed other ancillary businesses linked to the mobile services market. While tower companies and value-added services have hogged the limelight in the ancillary segment, the handset business has been completely ignored. Also, Nokia dominated the market and domestic brands were non-existent in the segment in India unti recently. In the past year though, as new operators launched services and offered free talk time, in the absence of MNP, dual-SIM handsets, which were launched by some Indian brands like Micromax and Spice a few years ago, gained popularity. Hence, even as the market continues to grow Nokia and other MNC brands like LG are losing market share to Indian brands.

We estimate that over 160 mn handsets were sold in India in FY10. India added over 200 mn mobile subscribers in FY10 and we estimate over 300 mn subscriber additions over FY10-13. We expect about 31% CAGR in handset sales during FY10-13E. The market currently is dominated by MNC brands with Nokia controlling half the market, although, it is believed (recent media reports) that its incremental market share in the past quarter has dropped significantly.

Table 17: Handset industry forecasts

	FY10	FY11E	FY12E	FY13E
Total no. of subscribers	584,323,402	740,682,305	841,683,435	884,044,426
Proportion of dual SIM subscribers in new adds (%)	17.0	25.0	30.0	30.0
New 2G handset sales for industry	148,815,853	109,200,000	69,360,000	34,272,000
Total replacement demand	13,036,937	124,471,934	212,313,191	301,372,922
Organised market share (%)	70.0	95.0	95.0	98.0
MNC market share (%)	75.0	60.0	50.0	50.0
India branded market share (%)	25.0	40.0	50.0	50.0
Unorganised market share (%)	30.0	5.0	5.0	2.0
3G handset sales for the industry	-	-	13,332,281	25,864,626
MNC market share (%)			80.0	65.0
India branded market share (%)			20.0	35.0
MNC	84,972,715	133,193,002	144,460,591	181,278,019
India branded	28,324,238	88,795,335	136,461,222	173,518,631
Unorganised	48,555,837	11,683,597	14,083,660	6,712,898
Total	**161,852,791**	**233,671,934**	**295,005,472**	**361,509,548**
ASP (INR)	2,100	2,100	2,100	2,100
Total revenue of India branded handsets (INR mn)	59,481	186,470	286,569	364,389
Net margins (%)	10.0	8.0	6.0	5.0
Net profit (INR)	5,948	14,918	17,194	18,219

Source: Media reports, Edelweiss research

Domestic brands import handsets after engaging with Original Design Manufacturers (ODMs) in China and sell in the Indian market under their own brand. Micromax is believed to be the leader among Indian brands with Spice being the second largest. Other popular Indian brands are Maxx, Karbonn, and Lava. Spice Mobility is the only listed player.

Table 18: Spice Mobile—Financial summary

	FY10
Price (INR)	86
Market capitalisation	6,418
Handsets sold (mn)	5.0
Revenues (INR mn)	10,398
EBITDA (INR mn)	1,007
Margin (%)	9.7
Net profit (INR mn)	703
Margin (%)	6.8

Source: Company

BHARTI AIRTEL

Edelweiss
Ideas create, values protect

Challenges ahead

September 20, 2010

Reuters: BRTI.BO	Bloomberg: BHARTI IN

Revenue market share to be challenged

We expect Bharti Airtel's (Bharti) current 32% revenue market share to be challenged by Idea, Tata Docomo, and Aircel. So far, the company has faced limited credible pan-India competition. In a few of the large circles (in terms of market size in value terms) like Karnataka, Delhi and Andhra Pradesh it has 40% or more revenue market share. But implementation of MNP and launch of 3G services will give its competitors an opportunity to target its superior quality subscriber base.

Industry-high margins at risk

Bharti reported EBITDA margin of 36% in its mobility business in Q1FY11 compared to 29% by RCOM and 28% by Idea (established circles). In order defend its revenue market share Bharti's customer retention cost is likely to rise significantly. We believe, launch of 3G services will lead to margin pressures.

Zain margin improvement targets already discounted

Bharti took over Zain Africa in June 2010 with a reported subscriber base of 43 mn, annual revenue run-rate of USD 3.6 bn, and EBITDA of USD 1.3 bn. In Q1FY11 results, the company consolidated Zain Africa for 23 days during the quarter and revised the active subscriber base to 36 mn. It reported annual revenue run-rate of USD3.3bn and EBITDA of USD 910mn. The street expects Bharti to achieve its stated target of revenue of USD 5 bn and EBITDA of USD 3.6 bn by FY13E and hence there is limited potential of a surprise.

Strong FCF generation FY12 onwards

Bharti generated free cash flow in FY10, but investments in 3G, BWA and Zain will be higher than its operating cash flow in FY11. We expect Bharti to generate strong free cash flows of over USD2bn p.a. FY12. But debt repayment of Zain will begin from FY13, thus the company will be debt free in FY15.

Outlook and valuation: Several challenges ahead; downgrade to **'HOLD'**

The street has turned optimistic on Bharti as it believes the worst is over. The stock is trading at a marginal discount to levels when its stock price peaked in February 2008 despite relatively lower organic growth, margins and ROCE and higher debt on balance sheet. The stock has risen 40% in the past three months outperforming the Nifty by 26%. In our view, the street is ignoring the quality of competition and seems confident that Bharti will defend revenue market share like in the past. Hence, we downgrade the stock to **'HOLD'** from 'BUY' and rate it as **'Sector Outperformer'.**

Financials

Year to March	FY09	FY10	FY11E	FY12E
Revenue (INR mn)	369,612	418,472	620,034	754,958
Rev. growth (%)	*36.8*	*13.2*	*48.2*	*21.8*
EBITDA (INR mn)	151,677	167,404	223,938	273,590
Net profit (INR mn)	84,698	88,737	76,260	94,606
Diluted EPS (INR)	22.3	23.4	20.1	24.9
EPS growth (%)	*26.4*	*4.8*	*(14.0)*	*24.1*
Diluted P/E (x)	16.4	15.7	18.2	14.7
EV/ EBITDA (x)	9.7	8.5	9.0	7.0
ROAE (%)	33.5	24.8	16.7	17.6
ROACE (%)	29.6	22.2	13.2	10.9

EDELWEISS 4D RATINGS	
Absolute Rating	HOLD
Rating Relative to Sector	Outperformer
Risk Rating Relative to Sector	Low
Sector Relative to Market	Underweight

Note:
Please refer last page of the report for rating explanation

MARKET DATA		
CMP	:	INR 366
52-week range (INR)	:	467 / 229
Share in issue (mn)	:	3,797.5
M cap (INR bn/USD mn)	:	1,389 /30,413
Avg. Daily Vol. BSE/NSE ('000)	:	9,672.7

SHARE HOLDING PATTERN (%)		
Promoters*	:	67.9
MFs, FIs & Banks	:	8.8
FIIs	:	16.7
Others	:	6.6
** Promoters pledged shares (% of share in issue)*	:	*NIL*

PRICE PERFORMANCE (%)

	Stock	Nifty	EW Telecom Index
1 month	17.9	8.1	14.0
3 months	38.6	13.6	29.1
12 months	(17.1)	20.2	(22.1)

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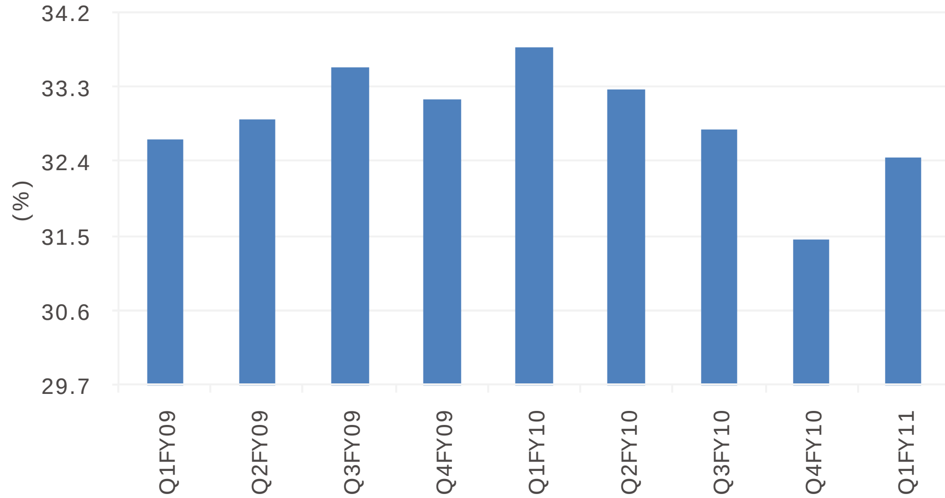
Revenue market share to be challenged

The advent of several new operators in the market in the past 15 months led to intense competition. It impacted Bharti's revenue market share—it declined marginally from 33.8% in Q1FY10 to 31.5% in Q4FY10 and recovered to 32.5% in Q1FY11. The company managed to defend revenue market share in a narrow band as it participated in the tariff wars by matching competitors' tariffs.

Chart 1: Bharti revenue market share movement



Source: TRAI

We expect Bharti to face stiff competition from stronger players like Idea, Tata Docomo, and Aircel and hence lose revenue market share. Also, after implementation of MNP we expect the company to be aggressive in a few circles where it has lower market share. For instance, in Mumbai, Bharti has only 10% subscriber share compared to an average of over 25% in metros and A circles. As it bid and won 3G licence for Mumbai for INR 33 bn, we believe, it will be compelled to achieve scale to generate its desired RoI. But TRAI data indicates that Bharti has the cream of subscribers in Mumbai since even with such low subscriber market share it has 20% revenue market share. Thus, we expect competition to chase Bharti subscribers in Mumbai.

Table 1: Bharti has the most lucrative subscriber base in almost all circles

	Bharti market share (%)		Vodafone market share (%)	
	Subscriber	Revenue	Subscriber	Revenue
A. P.	28.3	40.4	12.9	11.4
Assam	27.5	33.8	9.9	8.2
Bihar	29.7	46.8	9.4	8.6
Delhi	20.9	37.4	17.9	23.9
Gujarat	16.7	20.9	33.1	41.0
Haryana	10.2	17.8	20.3	25.9
H. P.	25.4	43.2	0.0	6.1
J & K	36.4	39.3	0.0	5.1
Karnataka	33.4	50.5	13.7	14.5
Kerala	12.8	19.1	17.7	21.7
Kolkata	16.5	28.6	21.3	30.8
M. P.	21.6	30.7	6.2	4.6
Maharashtra	14.7	20.8	16.9	21.5
Mumbai	10.9	20.2	18.1	33.4
Orissa	27.4	39.3	7.3	8.1
Punjab	22.8	37.2	15.1	17.0
Rajasthan	30.7	46.1	22.0	22.7
Tamil Nadu	19.8	33.3	16.5	20.7
U. P. (E)	20.6	34.1	22.9	20.0
U. P. (W)	13.7	15.4	21.0	36.9
West Bengal	22.5	29.1	28.4	37.0
North East	27.8	36.3	10.4	8.4

Source: TRAI

- **Tough to defend margins and revenue market share**

Tariff wars impacted margins more than market share for Bharti

Bharti's mobility margins stabilised in Q1FY11 after collapsing from 40.5% in Q1FY10 to 36.4% in Q4FY10 as competition compelled per second pricing and lower tariffs. Thus, while the street lauds the company's ability to defend margins, it ignores the competition's ability to force Bharti's margins down. Our key concern on the company is that competition will get stiffer once MNP is implemented and all 3G winners launch services. We fear that the high cost of offering 3G services may not lead to commensurate returns as we do not expect 3G licence holders to have a 'controlled' roll out of services. We believe most operators will endeavour to maximise coverage in atleast their key circles to gain the first mover advantage. On top, MNP will offer competition an opportunity to lure Bharti's high usage customers, due to which the company will have to increase in customer retention efforts.

- **Zain margin improvement targets already discounted**

Bharti took over Zain Africa in June 2010 with a reported subscriber base of 43 mn, annual revenue run-rate of USD 3.6 bn, and EBITDA of USD 1.3 bn. In Q1FY11 results, Bharti consolidated Zain Africa for 23 days during the quarter and revised the active subscriber base to 36 mn. It reported annual revenue run-rate of USD3.3bn and EBITDA of USD 910mn. But Bharti has indicated after taking over Zain it is targeting increasing subscriber base to 100 mn, revenues to USD 5 bn, and EBITDA to USD 2 bn by FY13E. The targets appear to be reasonable given the average teledensity in Africa of 25% and Bharti's track record of innovative cost management and the street is giving Bharti management benefit of the doubt. But it is worth noting that it took nearly six years for India to increase teledensity from 25% to the current 60%, during which Bharti reported revenue CAGR of 27% and EBITDA CAGR of 21%. Thus, Bharti's stated targets for Zain are challenging.

Strong FCF generation FY12 onwards

Bharti generated free cash flow for the first time in its history in FY10. In FY11, due to 3G and BWA licence fees and acquisition of Zain, investments in business far exceeded operating cash flow. But FY12 onwards we expect the company to generate strong free cash flows. But debt repayment of Zain will begin FY13 onwards, thus it will turn debt free only in FY15.

Can value be unlocked in towers?

The street has been valuing Bharti on sum-of–the-parts and adding value of its tower business to its core business value. In our view, the company's value in Indus Towers is 'locked'. We believe the three partners in Indus—Bharti, Vodafone, and Idea—have still not transferred the towers to Indus. Also, we believe there are certain disagreements between shareholders and hence listing of Indus Towers is unlikely in the near future. While Bharti Infratel could see some fund infusion through divestment of stake by Bharti to private equity investors or strategic investors, we believe it will be imprudent to adjust the entire implied value through such a stake sale to arrive at Bharti's core business value. Bharti is unlikely to be able to completely sell off its stake in Bharti Infratel and 'unlock' value. Thus, we refrain from using the sum-of-the-parts method to value Bharti. We, instead, use the traditional DCF method by considering Bharti's consolidated cash flows from all its business including tower assets.

Financial analysis

Bharti added 2mn subscribers in the month of August 2010 significantly lower than the average 2.8mn subscriber addition in the past six months. In our view, subscriber additions have become less material as a metric given the gross over reporting by operators of 'inactive' customers. Bharti reported MOU of 460 in FY10 and 480 in Q1FY11. We expect average MOU of 496 for FY11 and 510 for FY12. We expect RPM to decline by 8% from Q1FY11 levels by FY12 due to competition led by implementation of MNP. We expect 3G services revenues to contribute about 5% to overall mobility business revenues in FY12. We expect EBITDA margins to rise from Q1FY11 levels for the rest of the year but assume a marginal decline for FY12. We believe, we are being optimistic in our assumption of near stable margins in FY12 as we expect cost of doing business to rise.

Table 2: Financial snapshot

	FY10	FY11E	FY12E	*CAGR (%)*
Consolidated financials				
Revenue (INR mn)	418,472	620,034	754,958	*34.3*
EBITDA (INR mn)	167,404	223,938	273,590	*27.8*
Net profit (INR mn)	88,737	76,260	94,606	*3.3*
EBITDA margin (%)	*40.0*	*36.1*	*36.2*	
Net profit margin (%)	*21.2*	*12.3*	*12.5*	
India wireless subscribers	128	163	190	*22.1*
ARPU (INR)	243	217	210	*(7.0)*
RPM (INR)	0.5	0.4	0.4	*(11.8)*
MoU	460	496	510	*5.4*
Segment-wise snapshot				
Wireless				
India				
Revenue	322,810	379,402	447,667	*17.8*
EBITDA	124,781	138,425	159,510	*13.1*
EBITDA margin (%)	38.7	36.5	35.6	
Africa				
Revenue		135,777	178,615	
EBITDA		38,612	58,116	
EBITDA margin (%)		28.4	32.5	
Enterprise & corporate services				
Revenue	78,952	77,475	77,018	*(1.2)*
EBITDA	27,307	27,454	23,807	*(6.6)*
EBITDA margin (%)	34.6	35.4	30.9	
Telemedia				
Revenue	34,154	38,237	36,813	*3.8*
EBITDA	14,729	17,117	12,550	*(7.7)*
EBITDA margin (%)	43.1	44.8	34.1	
Passive infrastructure				
Revenue	44,798	39,238	40,205	*(5.3)*
EBITDA	12,578	10,337	11,257	*(5.4)*
EBITDA margin (%)	28.1	26.3	28.0	

Source: Company, Edelweiss research

- **Outlook and valuation: Street optimistic as 'worst is over'; downgrade to 'HOLD'**

  In our view, Bharti's high revenue market share in an otherwise fragmented market will be challenged frequently. The company is unlikely to trade at historical valuations given the pressure on its revenue market share and margins. The street believes that the 'worst is over' for Bharti and that is good enough reason to buy the stock. We agree that the worst is probably over for the company and we may not see RPM cracking by 23% in a span of just four quarters. But the current upgrades and optimism, in our view, are a little too early. Given the quality of competition, it would be prudent to let events such as MNP and 3G launch, whose impact on earnings is uncertain, to play out.

Bharti is currently trading at a marginal discount to levels when its stock price peaked in February 2008. This, despite minimal threat of competition, peak margins, near-zero debt on the balance sheet and peak ROCE then, each of which has reversed now.

Table 3: Bharti comparison with the peak

Particulars	Q4FY08	Q1FY11
Price (INR)	468	355
Market cap (INR mn)	1,774,537	1,347,509
No. of shares (mn)	3,796	3,796
Net debt (INR mn)	41,562	602,308
EV (INR mn)	1,816,099	1,949,817
Market cap/EV (x)	0.98	0.69
EBITDA (INR)	35,221	43,907
Shareholders equity (INR mn)	238,329	435,037
Susbcriber market share (%)	24.51	21.70
Revenue market share (%)	32.66	32.45
Top 3 competitors' combined revenue market share (%)	45.12	45.59
ARPU (INR)	357	215
MOU	507	480
Minutes (mn)	89,058	197,718
RPM (INR)	0.72	0.45
EBITDA per minute (INR)	0.26	0.17
Operating PBT margin (%)	25.4	16.9
ROCE (%)	33.8	18.7
Net debt/EBITDA (x)	0.30	3.43
Net debt/Equity (x)	0.17	1.38
Expected 2-year CAGR in revenues (%)	18.6	18.9
Expected EBITDA margin rise / (decline) over next two years	+400 bps	+260 bps
Expected 2-year CAGR in EBITDA (%)	30.1	25.8
2-year forward EV/EBITDA (x)	9.4	7.4
2-year forward P/E (x)	16.9	14.2

Source: Company, Bloomberg, Edelweiss research

Here are five reasons why Bharti needs to trade at a discount to levels seen at peak stock price:

1. **Threat from competition:** Bharti faced limited credible pan-India competition as it was the only pan-India operator uptil FY08 with BSNL being the only other operator with pan-India operations. Vodafone was focused primarily on metros, RCOM and Tata Docomo faced the handicap of being in the CDMA segment, Idea and Aircel were regional players. Now, as Vodafone's focus shifts from high-end customers to mass market, RCOM and Tata Docomo plan to monetize their GSM presence and Idea and Aircel provide credible pan-India competition, Bharti's dominant presence in the market will be severely challenged.

2. **Risk of inability to influence policy decisions:** In FY08, Bharti was perceived to possess the ability to maneuver policy decisions, for e.g., allocation of spectrum. But in the recent past, we believe, the company has had to face the onslaught of unfavorable policy decisions. With expanding presence in multiple geographies including India, Africa, Sri Lanka and Bangladesh, it faces an arduous task of navigating policy changes.

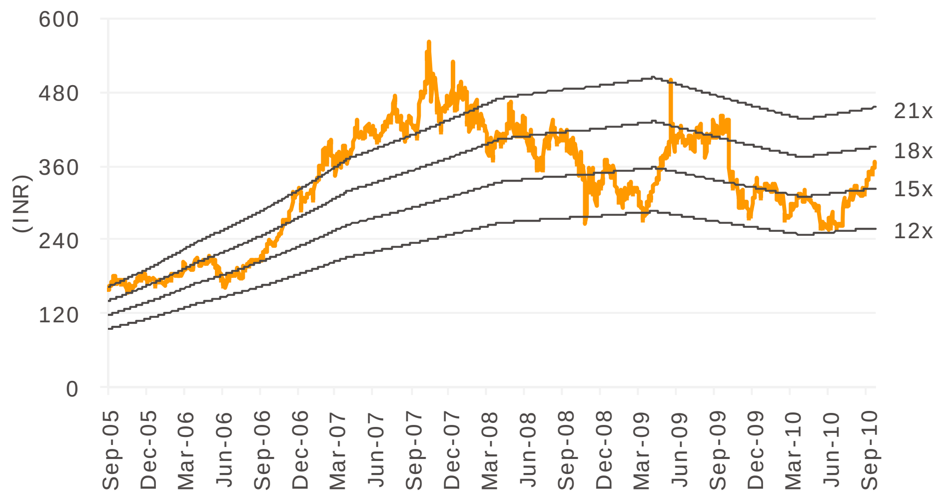
3. **Debt constitutes 31% of EV versus 2% in FY08:** Bharti's EV has remained stable over the past three years despite market capitalisation reducing as it has assumed significant amount of debt. While the company's market cap was 98% of its EV in FY08, it has dropped to 69% currently.

4. **ROCE dilution significant in past three years:** The company's dominant position in FY08 enabled it to generate ROCE of 31%. But due to dilution in profitability and spectrum constraints compelling it to incur more capex, its ROCE dropped to 18% in Q1FY11. With the acquisition of Zain and 3G and BWA licence fees, its ROCE is expected to drop further to 10.9% in FY12E.

5. **BWA, an investment unlikely to yield much return:** Bharti won BWA licence in four circles by paying INR 55bn fees. Given that Reliance Industries owned Infotel has won a pan-India BWA licence, Bharti is unlikely to have roaming arrangement with favourable terms. Thus, its BWA investment is unlikely to yield much return.

Our fair value for Bharti, as per DCF analysis, is INR 387 assuming a terminal growth of 4%. We expect over USD 2 bn FCF p.a. over the next four years and hence terminal value constitutes only 67% of its overall EV. While the street is considering sum-of–the-parts valuation for Bharti by valuing its tower assets separately, we do not expect Bharti to be able to exit Indus Towers or Bharti Infratel entirely. Thus, using consolidated cash flows for Bharti including Bharti Infratel and Indus towers in our DCF model we arrive at a fair value of INR 387. At the current price, we downgrade the stock to **'HOLD'** from 'BUY' and rate it as Sector Outperformer as we believe the expected medium-term pressure on business will disappoint the street.

Chart 2: One year forward P/E band



Source: Bloomberg, Edelweiss research

Company Description

Bharti is India's largest integrated telecom operator providing mobile, broadband and telephone services (B&T), and enterprise services. It is India's largest wireless operator with a pan-India mobility network spanning all 22 telecom circles; its B&T services are currently available in 95 cities. BHARTI had a wireless subscriber base of ~127.6 mn in FY10, implying wireless subscriber market share of ~22%. The enterprise services division provides carrier (long distance services) and other services to corporates. BHARTI has recently launched 2G and 3G services as the fifth mobile operator in Sri Lanka. It has also acquired 70% stake in Warid Telecom, Bangladesh's 4th largest telecom operator for USD 300 mn in January 2010. It acquired Zain to operate in the Africa market.

Investment Theme

We expect competitive intensity to increase following the implementation of MNP and launch of 3G services. We believe BHARTI is relatively well placed among Indian telecos given its scale of operations, strong execution capabilities and robust balance sheet. We expect the tough industry scenario to likely to dampen BHARTI's growth metrics in the near-term. The stock has out performed the broad indices over the past three months as the street has turned optimistic. We have turned cautious on the stock.

Key Risks

If operators maintain price discipline then Bharti will not only retain market share but will also be able to defend margins. Under-ownership of the stock could also lead to continued stock out performance.

Financial Statements

Income statement (INR mn)

Year to March	FY08	FY09	FY10	FY11E	FY12E
Gross revenues	311,186	468,096	486,904	699,568	848,267
Inter segment	40,936	98,484	68,432	79,534	93,309
Net revenues	270,250	369,612	418,472	620,034	754,958
Direct costs	96,658	126,741	175,712	268,624	333,396
Employee costs	14,779	16,990	19,028	27,824	30,953
Other expenses	45,099	74,204	56,328	99,647	117,018
Total operating expenses	156,536	217,935	251,068	396,096	481,368
EBITDA	113,714	151,677	167,404	223,938	273,590
Depreciation and amortisation	37,260	47,581	62,835	106,060	136,343
EBIT	76,454	104,096	104,569	117,879	137,247
Interest expenses	4,054	4,418	17,559	25,625	18,893
Other income	4,136	(6,606)	17,050	1,518	669
Profit before tax	76,536	93,072	104,060	93,772	119,022
Provision for tax	8,379	6,615	13,453	16,900	23,804
Core profit	68,157	86,457	90,607	76,872	95,218
Profit after tax	68,157	86,457	90,607	76,872	95,218
Minority interest	1,150	1,759	1,870	612	612
Profit after minority interest	67,007	84,698	88,737	76,260	94,606
Equity shares outstanding (mn)	3,796	3,796	3,796	3,794	3,794
EPS (INR) basic	17.7	22.3	23.4	20.1	24.9
Diluted shares (mn)	3,796	3,796	3,796	3,794	3,794
EPS (INR) fully diluted	17.7	22.3	23.4	20.1	24.9
CEPS (INR)	27.5	34.8	39.9	48.1	60.9
Dividend per share	-	1.0	1.0	1.0	1.0
Dividend payout %	-	5.1	4.9	5.8	4.7

Common size metrics- as % of net revenues

Year to March	FY08	FY09	FY10	FY11E	FY12E
Operating expenses	57.9	59.0	60.0	63.9	63.8
Depreciation	13.8	12.9	15.0	17.1	18.1
Interest expenditure	1.5	1.2	4.2	4.1	2.5
EBITDA margins	42.1	41.0	40.0	36.1	36.2
Net profit margins	25.2	23.4	21.7	12.4	12.6

Growth metrics (%)

Year to March	FY08	FY09	FY10	FY11E	FY12E
Revenues	45.4	36.8	13.2	48.2	21.8
EBITDA	52.6	33.4	10.4	33.8	22.2
PBT	56.6	21.6	11.8	(9.9)	26.9
Net profit	58.4	26.9	4.8	(15.2)	23.9
EPS	57.2	26.4	4.8	(14.0)	24.1

Balance sheet (INR mn)

As on 31st March	FY08	FY09	FY10	FY11E	FY12E
Equity capital	18,979	18,979	18,988	18,988	18,988
Reserves & surplus	198,063	284,964	402,952	474,774	564,941
Shareholders funds	217,042	303,943	421,940	493,762	583,929
Minority Interest	8,556	10,704	25,285	32,847	32,847
Secured loans	77,715	53,993	81,474	595,000	500,000
Unsecured loans	19,348	64,808	20,424	84,000	84,000
Borrowings	97,063	118,801	101,898	679,000	584,000
Other non-current liabilities	15,195	18,162	49,261	70,599	82,430
Sources of funds	**337,856**	**451,610**	**598,384**	**1,276,208**	**1,283,206**
Gross block	409,639	549,810	697,246	838,996	980,746
Accumulated depreciation	96,232	140,674	214,617	320,677	457,020
Net block	313,407	409,136	482,629	518,319	523,726
Total fixed assets	313,407	409,136	482,629	518,319	523,726
Goodwill & Intangibles	40,247	40,364	59,890	636,179	628,374
Investments	48,194	38,053	70,753	23,620	23,620
Inventories	1,142	963	484	812	998
Sundry debtors	28,062	28,528	35,711	52,660	64,120
Cash and equivalents	6,777	11,145	25,323	63,373	59,884
Other current assets	29,715	65,518	23,661	124,007	150,992
Total current assets	65,696	106,154	85,179	240,852	275,993
Sundry creditors and others	131,267	151,548	108,409	178,243	206,988
Provisions	3,520	791	410	1,370	2,054
Total CL & provisions	134,787	152,339	108,819	179,613	209,042
Net current assets	(69,091)	(46,185)	(23,640)	61,239	66,950
Net Deferred tax			8,752	36,850	40,535
Misc expenses not w/o	5,099	10,242	0	0	-
Uses of funds	**337,856**	**451,610**	**598,384**	**1,276,208**	**1,283,206**
Book value per share (BV) (INR)	57	80	111	130	154

Free cash flow

Year to March	FY08	FY09	FY10	FY11E	FY12E
Net profit	68,157	86,457	90,607	76,872	95,218
Depreciation	37,260	47,581	62,835	106,060	136,343
Others	1,518	(9,911)	4,290	17,544	8,038
Gross cash flow	106,935	124,127	157,732	200,476	239,599
Less: Changes in W. C.	(15,519)	18,538	8,367	46,830	9,200
Operating cash flow	122,454	105,588	149,365	153,647	230,399
Less: Capex	135,374	140,171	147,436	718,039	141,750
Free cash flow	**(12,920)**	**(34,582)**	**1,930**	**(564,392)**	**88,649**

Cash flow metrices

Year to March	FY08	FY09	FY10	FY11E	FY12E
Operating cash flow	122,454	105,588	149,365	153,647	230,399
Financing cash flow	60,179	23,639	9,789	577,102	(95,000)
Investing cash flow	(135,448)	(140,151)	(147,507)	(718,039)	(141,750)
Net cash flow	47,185	(10,923)	11,648	12,710	(6,351)
Capex	(135,374)	(140,171)	(147,436)	(718,039)	(141,750)
Dividends paid	-	(4,441)	(4,441)	(4,438)	(4,438)

Profitability & liquidity ratios

Year to March	FY08	FY09	FY10	FY11E	FY12E
ROAE (%)	39.0	33.5	24.8	16.7	17.6
ROACE (%)	31.3	29.6	22.2	13.2	10.9
Current ratio	0.5	0.7	0.8	1.3	1.3
Debtors (days)	31	28	28	26	28
Fixed assets t/o (x)	1.0	1.0	0.9	1.2	1.4
Average working capital t/o (x)	(4.4)	(6.4)	(12.0)	33.0	11.8
Debt/Equity	0.4	0.4	0.2	1.4	1.0
Debt/EBITDA	0.9	0.8	0.6	3.0	2.1
Adjusted debt/Equity	0.4	0.4	0.2	1.8	1.5

Operating ratios

Year to March	FY08	FY09	FY10	FY11E	FY12E
Total asset turnover	1.0	0.9	0.8	0.7	0.6
Fixed asset turnover	1.0	1.0	0.9	1.2	1.4
Equity turnover	1.5	1.4	1.2	1.4	1.4

Du pont analysis

Year to March	FY08	FY09	FY10	FY11E	FY12E
NP margin (%)	24.8	22.9	21.2	12.3	12.5
Total assets turnover	1.0	0.9	0.8	0.7	0.6
Leverage multiplier	1.6	1.6	1.5	2.0	2.4
ROE (%)	39.0	33.5	24.8	16.7	17.6

Valuation parameters

Year to March	FY08	FY09	FY10	FY11E	FY12E
Diluted EPS (INR)	17.7	22.3	23.4	20.1	24.9
Y-o-Y growth	*57.2*	*26.4*	*4.8*	*(14.0)*	*24.1*
CEPS (INR)	27.5	34.8	39.9	48.1	60.9
Diluted P/E (x)	20.8	16.4	15.7	18.2	14.7
Price/BV(x)	6.4	4.6	3.3	2.8	2.4
EV/Sales (x)	5.3	4.0	3.4	3.2	2.5
EV/EBITDA (x)	12.7	9.7	8.5	9.0	7.0

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IDEA CELLULAR

Strong brand positioning

Edelweiss
Ideas create, values protect

- ## Innovative marketing and branding helping grab market share

Idea Cellular's (Idea) brilliant marketing and branding efforts have yielded the desired results as it has become the third largest mobile operator by revenues in India. The operator has carried 32 bn incremental minutes over the past three quarters, 68% of Bharti's, even as Idea's actual minutes of traffic is just 43% of Bharti's. This, we believe, is due to the comapany marketing efforts, which position it as a brand for all age groups. While the operator shares a good relationship with both Bharti and Vodafone, the two will face the highest risk of competition from it.

- ## MNP and 3G offer significant opportunity

Idea, from being the fifth largest operator in India two years ago has overtaken BSNL and RCOM to become the third largest currently. It had a focused 3G spectrum bid strategy with subscriber/revenue coverage of 81%/82% relative to Bharti (65%/68%) and Vodafone (61%/69%). Out of the 11 circles that Idea won a 3G licence in four circles (Andhra Pradesh, Karnataka, Tamil nadu and Uttar Pradesh (W)), its current ARPU is lower by 40% to Bharti's. Its strong branding will enable it to gain share due to MNP.

- ## Highest operating leverage potential

The company generated EBITDA margin of 31% in FY10 in established circles, whereas Bharti generated 39%. Idea launched operations in seven circles in FY09, in which it is currently incurring losses. Thus, its consolidated margins are at 25%. As operations in new circles turnaround and achieve stable state margins of about 30%, Idea's overall margins will expand and thus the company offers the highest operating leverage potential.

- ## Outlook and valuations: Deserves premium valuations; maintain **'HOLD'**

The stock has, historically, traded at a premium to Bharti and Rcom as it was perceived to be an acquisition target. Recent media reports suggest that it is in talks to divest 26% stake. We believe Idea deserves to trade at a premium due to the increase in market share and the operating leverage story. We forecast Idea's EBITDA to post 21% CAGR over FY10-12E, but it is trading at 7.6x FY12E EV/EBITDA. Hence, we maintain **'HOLD'** recommendation and rate it **'Sector Performer'** on relative return basis.

Financials

Year to March	FY09	FY10	FY11E	FY12E
Net revenues (INR mn)	101,258	124,494	147,506	162,503
Rev. growth (%)	*50.7*	*22.9*	*18.5*	*10.2*
EBIDTA (INR mn)	28,359	34,071	39,764	49,645
Net profit (INR mn)	9,015	8,702	6,431	6,561
Shares outstanding (mn)	3,300	3,300	3,300	3,300
Diluted EPS (INR)	2.9	2.6	1.9	2.0
Y-o-Y growth (%)	*(26.5)*	*(9.3)*	*(26.1)*	*2.0*
P/E (x)	26.4	29.1	39.4	38.6
EV/ EBITDA	10.4	9.3	9.5	7.6
ROAE (%)	10.7	7.1	5.5	5.3
ROACE (%)	9.6	7.0	6.6	7.2

September 20, 2010

Reuters: IDEA.BO *Bloomberg: IDEA IN*

EDELWEISS 4D RATINGS	
Absolute Rating	**HOLD**
Rating Relative to Sector	**Performer**
Risk Rating Relative to Sector	**Medium**
Sector Relative to Market	**Underweight**

Note:
Please refer last page of the report for rating explanation

MARKET DATA		
CMP	:	INR 77
52-week range (INR)	:	79 / 47
Share in issue (mn)	:	3,300.2
M cap (INR bn/USD mn)	:	254 /5,556
Avg. Daily Vol. BSE/NSE ('000)	:	7,814.8

SHARE HOLDING PATTERN (%)		
Promoters*	:	47.0
MFs, FIs & Banks	:	7.7
FIIs	:	6.1
Others	:	39.3
** Promoters pledged shares (% of share in issue)*	:	*NIL*

PRICE PERFORMANCE (%)

	Stock	Nifty	EW Telecom Index
1 month	9.8	8.1	14.0
3 months	43.2	13.6	29.1
12 months	0.0	20.2	(22.1)

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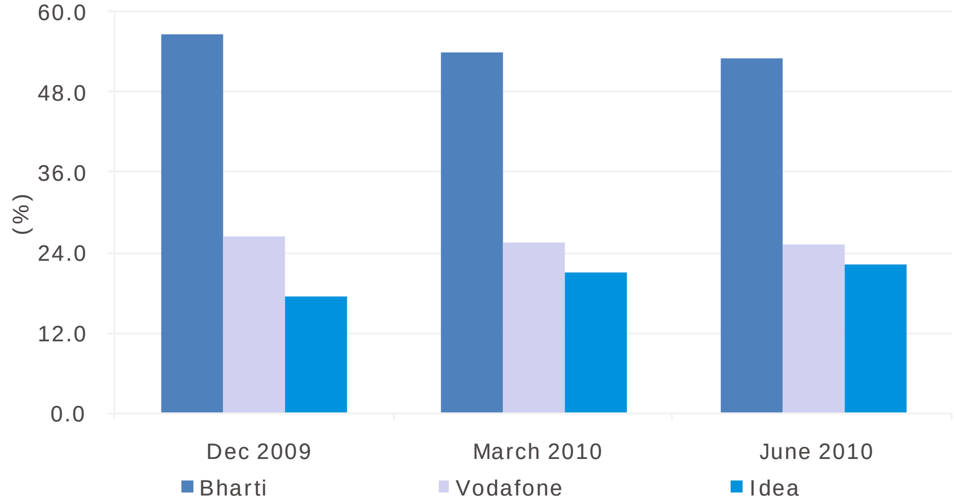
Innovative marketing and branding helping grab market share

Idea has created a strong brand

Idea's brilliant marketing and branding efforts have yielded the desired results as it has become the third largest mobile operator by revenues in the country. The operator has carried 32 bn incremental minutes over the past three quarters, 68% of Bharti, even as Idea's actual minutes of traffic is just 43% of Bharti's. This, we believe, is due to Idea's marketing efforts, which position it as a brand for all age groups. While the operator shares a good relationship with both Bharti and Vodafone, it probably stands to gain most from implementation of MNP vis a vis the other two.

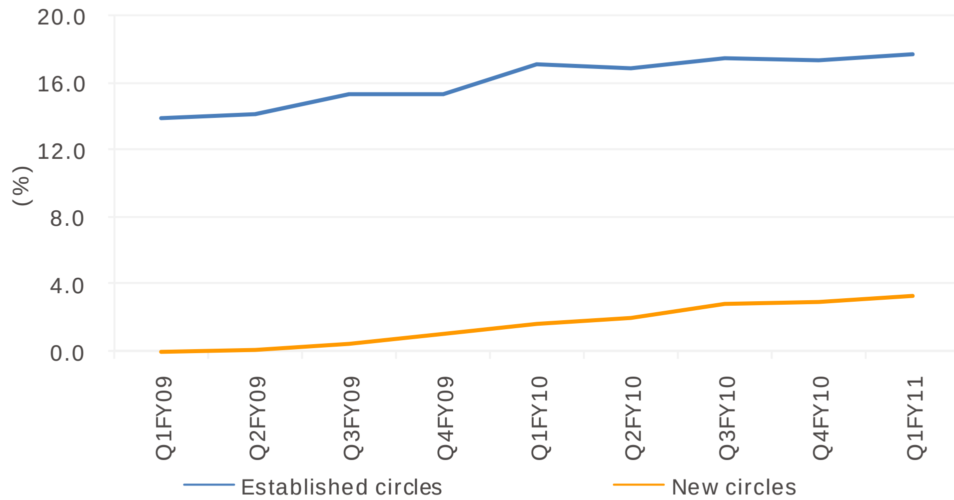
Chart 1: Idea gaining volume (minutes) market share



Source: Companies, Edelweiss research

Idea has been gaining market share not only in its established circles like Kerala, Madhya Pradesh, and Punjab, but also in circles where it launched services 6-8 quarters ago like Mumbai and Bihar. The operator's revenue market share in established circles has increased from 15.3% in Q4FY09 to 17.6% in Q1FY11 and its market share in new circles has risen to 3.3% since launch.

Chart 2: Revenue market share



Source: TRAI

Idea's ARPUs are lower by 40% to Bharti's in some key circles

MNP and 3G: A big opportunity

Idea, from being the fifth largest operator in India two years ago, has overtaken BSNL and RCOM to become the third largest currently. While the gap between it and the top two operators Bharti and Vodafone is wide, we believe Idea's branding and marketing will enable it to capture share from its larger peers. It had a focused 3G spectrum bid strategy with subscriber/revenue coverage of 81%/82% relative to BHARTI (65%/68%) and Vodafone (61%/69%).

In four circles (Andhra Pradesh, Karnataka, Tamil nadu and Uttar Pradesh (W)) out of the 11 circles that Idea won a 3G license in, its current ARPU is 40% lower than its closest competitors Bharti and Vodafone. In Tamilnadu its ARPU is just INR 82 compared to INR 255 for Bharti and INR 191 for Vodafone. On implementation of MNP, due to its strong brand, Idea will have the opportunity to chase these subscribers with attractive schemes.

Table 1: Opportunity for Idea to gain share

	Idea		Bharti		Vodafone		BSNL	
	Revenue market share (%)	ARPU (INR)	Revenue market share (%)	ARPU (INR)	Revenue market share (%)	ARPU (INR)	Revenue market share (%)	ARPU (INR)
Established circles								
A. P.	16.3	199	40.4	238	11.4	148	8.5	137
Delhi	9.7	288	37.4	492	23.9	367	3.6	116
Gujarat	17.8	177	20.9	203	41.0	200	4.7	77
H. P.	7.4	189	43.2	227	6.1		15.0	76
Haryana	19.9	179	17.8	231	25.9	172	14.4	103
Karnataka	6.6	165	50.5	272	14.5	190	6.1	103
Kerala	29.4	221	19.1	250	21.7	207	14.3	144
M. P.	31.2	171	30.7	183	4.6	98	5.9	64
Maharashtra	29.9	223	20.8	223	21.5	207	6.3	89
Punjab	18.9	216	37.2	295	17.0	204	10.8	102
Rajasthan	7.6		46.1	192	22.7	131	8.4	76
U. P. (E)	12.0	155	34.1	180	20.0	95	14.7	82
U. P. (W)	23.1	194	15.4	179	36.9	275	6.7	90
New circles								
Assam	1.0	154	33.8	206	8.2	143	11.5	148
Bihar	8.0	113	46.8	187	8.6	113	6.6	62
J & K	1.1	181	39.3	219	5.1		16.6	181
Kolkata	1.6		28.6	252	30.8	212	5.0	59
Mumbai	5.9	242	20.2	431	33.4	425	3.2	71
North East	0.6		36.3	232	8.4	149	16.5	144
Orissa	2.5	79	39.3	176	8.1	139	14.7	106
Tamil Nadu	0.8	82	33.3	255	20.7	191	8.0	107
West Bengal	1.7	-	29.1	144	37.0	142	7.8	89

Source: TRAI

Highest operating leverage potential

Idea generated EBITDA margin of 31% in FY10 in its established circle operations whereas Bharti generated 39% in its mobility business. The company launched operations in nine circles in FY09, in which it is currently incurring losses. Thus, its consolidated margins were 25% in FY10. As operations in new circles turnaround and achieve stable state margins of about 30%, Idea's overall margins will expand and thus the company offers the highest operating leverage potential.

Margins likely to dip in FY11 but expand in FY12

Idea added 2.2 mn subscribers in August 2010. We expect the run rate to continue as it increases its share in new circles and gains share on implementation of MNP. We expect revenue growth of 19% and 14% in FY11E and FY12E, respectively. While we expect EBITDA margins to decline in FY11, losses in new circles are likely to reduce and hence margins will expand in FY12.

Table 2: Financial forecasts

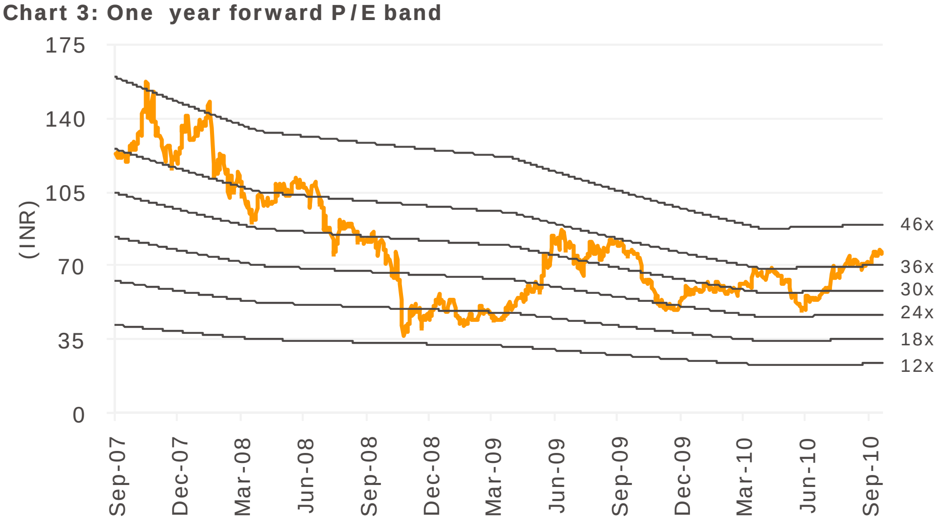
	FY10	FY11E	FY12E	*CAGR (%)*
Consolidated financials				
Revenue (INR mn)	124,494	147,506	162,503	*14.2*
EBITDA (INR mn)	34,071	39,764	49,645	*20.7*
Net profit (INR mn)	9,539	6,431	6,561	*(17.1)*
EBITDA margin (%)	*27.4*	*27.0*	*30.6*	
Net profit margin (%)	*7.7*	*4.4*	*4.0*	
Wireless subscribers	64	83	94	*21.1*
ARPU (INR)	198	168	149	*(13.4)*
RPM (INR)	0.5	0.4	0.4	*(9.3)*
MoU	377	388	343	*(4.5)*

Source: Company, Edelweiss research

Outlook and valuations: Deserves premium valuations; maintain **'HOLD'**

The Idea stock has, historically, traded at a premium to Bharti and RCOM as it was perceived that existing promoters will sell off their stake to another strategic investor, which could trigger an open offer for minority investors. Recently such talks have resurfaced in the media. We believe the stock deserves to trade at a premium due to the increase in market share and the operating leverage story. We forecast Idea's EBITDA to post 21% CAGR over FY10-12E, but it is trading at 7.6x FY12E EV/EBITDA. Hence, we maintain **'HOLD'** recommendation on the stock and rate it **'Sector Performer'** on relative return basis.

Chart 3: One year forward P/E band



Source: Bloomberg, Edelweiss research

Company Description

Idea is India's fifth largest telecom operator with a subscriber base of 63 mn and third largest with revenue market share of ~13% in FY10. The company is a pure play GSM operator with pan-India operations including two circles of Punjab and Karnataka which it obtained via acquisition of Spice Communication. Idea is the incumbent licensee in seven circles of operation and is the market leader in three circles of Maharashtra, Haryana, and Uttar Pradesh (West).

Investment Theme

We expect competitive intensity to increase following the implementation of MNP and launch of 3G services. Idea, due to its strong branding, will have an opportunity to increase market share due to MNP. Its margins are expected to improve as the operations in its new circles turnaround and rise to stable state margins. It is expected to report CAGR of 21% in EBITDA over the next two years.

Key Risks

We expect Idea to gain market share due to MNP. If incumbents like Bharti and Vodafone get aggressive and defend market share successfully and other operators like Tata Docomo, RCOM and Aircel target Idea customers, then its market share will be at risk. If the new circles fail to turnaround then margin improvement will not happen.

Financial Statements

Income statement **(INR mn)**

Year to March	FY08	FY09	FY10*	FY11E**	FY12E**
Gross revenues	67,200	103,527	135,538	162,712	180,542
Inter segment	0	(2,269)	(11,044)	(15,206)	(18,039)
Net revenues	67,200	101,258	124,494	147,506	162,503
Direct costs	28,656	50,615	73,706	84,260	90,490
Employee costs	3,464	5,252	6,674	6,778	7,558
Other expenses	12,563	17,032	10,044	16,704	14,810
Total operating expenses	44,682	72,899	90,424	107,742	112,858
EBITDA	22,518	28,359	34,071	39,764	49,645
Depreciation and amortisation	8,768	14,039	20,149	24,997	31,152
EBIT	13,750	14,320	13,922	14,767	18,493
Interest expenses	2,776	8,379	7,041	7,411	10,561
Other income	175	3,436	3,036	523	139
Profit before tax	11,148	9,377	9,917	7,879	8,071
Provision for tax	725	362	1,215	1,448	1,510
Core profit	10,423	9,015	8,702	6,431	6,561
Extraordinary items	0	0	837	0	0
Profit after tax	10,423	9,015	9,539	6,431	6,561
Profit after minority interest	10,423	9,015	9,539	6,431	6,561
Equity shares outstanding (mn)	2,635	3,100	3,300	3,300	3,300
EPS (INR) basic	4.0	2.9	2.6	1.9	2.0
Diluted shares (mn)	2,635	3,100	3,300	3,344	3,344
EPS (INR) fully diluted	4.0	2.9	2.6	1.9	2.0
CEPS (INR)	7.3	7.4	8.7	9.5	11.4

**includes 41.09% share of SPCM financials till 28/2/2010 and 100% SPCM financials for the month of Mar-10*

***includes 100% SPCM financials*

Common size metrics- as % of net revenues

Year to March	FY08	FY09	FY10	FY11E	FY12E
Operating expenses	66.5	72.0	72.6	73.0	69.4
Depreciation	13.0	13.9	16.2	16.9	19.2
Interest expenditure	4.1	8.3	5.7	5.0	6.5
EBITDA margins	33.5	28.0	27.4	27.0	30.6
Net profit margins	15.5	8.9	7.0	4.4	4.0

Growth metrics (%)

Year to March	FY08	FY09	FY10	FY11E	FY12E
Revenues	53.9	50.7	22.9	18.5	10.2
EBITDA	53.7	25.9	20.1	16.7	24.9
PBT	118.9	(15.9)	5.8	(20.5)	2.4
Net profit	107.5	(13.5)	(3.5)	(26.1)	2.0
EPS	104.2	(26.5)	(9.3)	(26.1)	2.0

Balance sheet (INR mn)

As on 31st March	FY08	FY09*	FY10*	FY11E**	FY12E**
Equity capital	26,354	31,001	32,998	32,998	32,998
Preference capital	0	19	19	19	19
O/s ESOP	38	182	444	444	444
Reserves & surplus	9,055	101,451	80,261	86,692	93,253
Shareholders funds	35,446	132,653	113,722	120,153	126,714
Secured loans	54,549	65,452	65,264	65,264	66,396
Unsecured loans	10,605	23,670	13,329	65,421	63,658
Borrowings	65,154	89,122	78,592	130,685	130,054
Other non-current liabilities	661	1,130	2,142	2,296	2,296
Sources of funds	**101,261**	**222,905**	**194,457**	**253,134**	**259,064**
Gross block	110,141	178,313	243,663	359,031	395,268
Accumulated depreciation	31,242	59,971	88,907	113,904	145,056
Net block	78,899	118,342	154,756	245,127	250,212
Capital Work in Progress	10,372	21,409	5,465	4,727	4,727
Total fixed assets	89,270	139,750	160,221	249,854	254,939
Intangible assets	17,892	26,922	26,922	26,922	26,922
Goodwill	61	22,457	61	61	61
Investments	5,560	20,452	-	-	-
Inventories	276	521	617	716	757
Sundry debtors	1,986	3,618	4,783	5,548	5,867
Cash and equivalents	4,975	30,864	14,204	4,056	3,754
Loans and advances	7,742	16,821	26,738	29,112	30,695
Other current assets	521	1,861	3,208	3,208	3,208
Total current assets	15,500	53,685	49,550	42,641	44,282
Sundry creditors and others	26,203	38,637	41,145	62,386	62,832
Provisions	819	1,724	1,153	3,957	4,307
Total CL & provisions	27,022	40,361	42,297	66,343	67,140
Net current assets	(11,523)	13,324	7,253	(23,702)	(22,857)
Uses of funds	**101,261**	**222,905**	**194,457**	**253,134**	**259,064**
Book value per share (BV) (INR)	13	43	34	36	38

**Balance sheet includes 100% of SPCM as of Mar-10 and 41.09% of SPCM as of Mar-09, and 16% of Indus for both Mar-09 and Mar-10*

***includes 100% SPCM financials*

Free cash flow

Year to March	FY08	FY09	FY10	FY11E	FY12E
Net profit	10,423	9,015	9,539	6,431	6,561
Depreciation	8,768	14,039	20,149	24,997	31,152
Gross cash flow	19,191	23,054	29,688	31,428	37,713
Less: Changes in W. C.	(1,437)	(1,042)	10,589	(20,807)	1,147
Operating cash flow	20,629	24,096	19,099	52,235	36,566
Less: Capex	44,817	79,209	49,407	114,629	36,237
Free cash flow	**(24,188)**	**(55,112)**	**(30,308)**	**(62,394)**	**329**

Cash flow metrices

Year to March	FY08	FY09	FY10	FY11E	FY12E
Operating cash flow	20,629	24,096	19,099	52,235	36,566
Financing cash flow	23,074	122,428	(8,533)	52,092	(631)
Investing cash flow	(50,365)	(94,101)	(49,407)	(114,629)	(36,237)
Net cash flow	(6,662)	52,424	(38,841)	(10,302)	(302)
Capex	(44,817)	(79,209)	(49,407)	(114,629)	(36,237)

Profitability & liquidity ratios

Year to March	FY08	FY09	FY10	FY11E	FY12E
ROAE (%)	36.4	10.7	7.1	5.5	5.3
ROACE (%)	17.2	9.6	7.0	6.6	7.2
Current ratio	0.6	1.3	1.2	0.6	0.7
Debtors (days)	10	10	12	13	13
Fixed assets t/o (x)	1.0	0.9	0.8	0.7	0.6
Average working capital t/o (x)	(16.0)	112.4	12.1	(17.9)	(7.0)
Debt/Equity	1.8	0.7	0.7	1.1	1.0
Debt/EBITDA	2.9	3.1	2.3	3.3	2.6
Adjusted debt/Equity	1.8	0.7	0.7	1.1	1.0

Operating ratios

Year to March	FY08	FY09	FY10	FY11E	FY12E
Total asset turnover	0.8	0.6	0.6	0.7	0.6
Fixed asset turnover	1.1	1.0	0.9	0.7	0.7
Equity turnover	2.3	1.2	1.0	1.3	1.3

Du pont analysis

Year to March	FY08	FY09	FY10	FY11E	FY12E
NP margin (%)	15.5	8.9	7.0	4.4	4.0
Total assets turnover	0.8	0.6	0.6	0.7	0.6
Leverage multiplier	2.9	1.9	1.7	1.9	2.1
ROE (%)	36.4	10.7	7.1	5.5	5.3

Valuation parameters

Year to March	FY08	FY09	FY10	FY11E	FY12E
Basic EPS (INR)	4.0	2.9	2.6	1.9	2.0
Y-o-Y growth	104.2	(26.5)	(9.3)	(26.1)	2.0
CEPS (INR)	7.3	7.4	8.7	9.5	11.4
Diluted P/E (x)	19.4	26.4	29.1	39.4	38.6
Price/BV(x)	5.7	1.8	2.2	2.1	2.0
EV/Sales (x)	3.9	2.9	2.6	2.6	2.3
EV/EBITDA (x)	11.6	10.4	9.3	9.5	7.6

RELIANCE COMMUNICATIONS

Defensive strategy

September 20, 2010

Reuters: RLCM.BO Bloomberg: RCOM IN

Focusing on customer retention than acquisition

Reliance Communication's (Rcom) revenue market share has fallen from a peak of 14% in Q2FY09, when it was the third largest operator in India, to 11% in Q1FY11 to become the fourth largest operator. It has won 3G licences in Mumbai and Delhi, where it already has 16% and 13% revenue market share, respectively, and competes with Bharti and Vodafone. But it did not win a licence in any of the A circles, where its average revenue market share is 8.8%. In our view, post MNP, having a 3G licence in these circles would have presented RCOM a huge opportunity to increase revenue market share. We believe the comapny is adopting a defensive strategy and focusing on defending revenue market share than increasing it.

Core business metrics: No sign of revival; deviation in trend to peers

The company, in the recent past, was the only large operator to re-initiate tariff wars. But it failed to garner market share. While competitors Bharti, Vodafone, and Idea posted double-digit growth in volume (minutes) Q-o-Q over the past two quarters, RCOM has not seen customers returning to its network. The company states that discontinuation of free minutes, decline in its PCO business, and customer churn initiated by the company prevented metrics improvement. It is also surprising that despite initiating tariff wars, its RPM declined by just 7.7% in the past three quarters compared to over 20% for Bharti, Vodafone, and Idea.

De-leveraging, a necessity

RCOM's intentions to de-leverage are well known. But recent news flow on its plans to deleverage has been extremely disappointing. Its talks with GTL Infra for sale of tower assets have fallen through. Recent media reports on the stake sale to a strategic investor have also not been encouraging.

Outlook and valuations: More an event play; downgrade to **'REDUCE'**

We expect RCOM to pull up its socks to improve market share on MNP implementation. In our view, it needs to invest in brand makeover and change customers' perception to gain market share. RCOM currently has debt of INR 320 bn, 3.9x FY11E EBITDA. It needs to deleverage its balance sheet to be able to focus on growth. At 7.1x FY12E EV/EBITDA we prefer Idea over RCOM. Hence, we are downgrading our recommendation on the stock to **'REDUCE'** from **'HOLD'**. On relative return basis we rate it "**Sector Underperformer".**

Financials

Year to March	FY09	FY10	FY11E	FY12E
Net revenues (INR mn)	229,416	221,323	225,787	251,587
Rev. growth (%)	*20.3*	*(3.5)*	*2.0*	*11.4*
EBIDTA (INR mn)	92,877	78,205	73,089	81,937
Net profit (INR mn)	59,154	46,925	21,203	22,868
Shares outstanding (mn)	2,064	2,064	2,064	2,064
Diluted EPS (INR)	27.7	22.0	9.9	10.7
Y-o-Y growth (%)	*9.5*	*(20.7)*	*(54.8)*	*7.9*
P/E (x)	6.3	8.0	17.6	16.3
EV/ EBITDA (x)	7.0	7.2	8.5	7.1
ROAE (%)	16.6	10.9	4.7	4.9

EDELWEISS 4D RATINGS

Absolute Rating	**REDUCE**
Rating Relative to Sector	**Underperformer**
Risk Rating Relative to Sector	**High**
Sector Relative to Market	**Underweight**

Note:
Please refer last page of the report for rating explanation

MARKET DATA

CMP	:	INR 175
52-week range (INR)	:	319 / 131
Share in issue (mn)	:	2,064.0
M cap (INR bn/USD mn)	:	361 /7,903
Avg. Daily Vol. BSE/NSE ('000)	:	8,066.3

SHARE HOLDING PATTERN (%)

Promoters*	:	67.7
MFs, FIs & Banks	:	9.4
FIIs	:	8.0
Others	:	14.9
** Promoters pledged shares (% of share in issue)*	:	*NIL*

PRICE PERFORMANCE (%)

	Stock	Nifty	EW Telecom Index
1 month	8.3	8.1	14.0
3 months	(4.4)	13.6	29.1
12 months	(42.4)	20.2	(22.1)

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RCOM left out lucrative circles in 3G where it has low market share

Defensive 3G strategy could impact future market share

RCOM has lost market share based on revenues, subscribers, and total minutes. While all its larger peers have seen traffic returning to their networks, RCOM has been reporting flat volumes over the past two quarters. In our view, implementation of MNP is a big opportunity for smaller players like Idea, Aircel, Tata Docomo including RCOM to target the Bharti and Vodafone subscriber base. But RCOM's 3G licence wins seem to suggest that it was focused on defending its market share. In metros it won 3G licence in Mumbai, Delhi, and Kolkata where it has an average 15% revenue market share. In Category A circles, which constitute 38% of mobile industry revenues (RCOM has just 9% revenue share), it did not win any licence. In our view, it should have bid aggressively in Category A circles as MNP would provide an opportunity to target Bharti and Vodafone customers.

Table 1: RCOM won 3G licence in circles where it has high market share

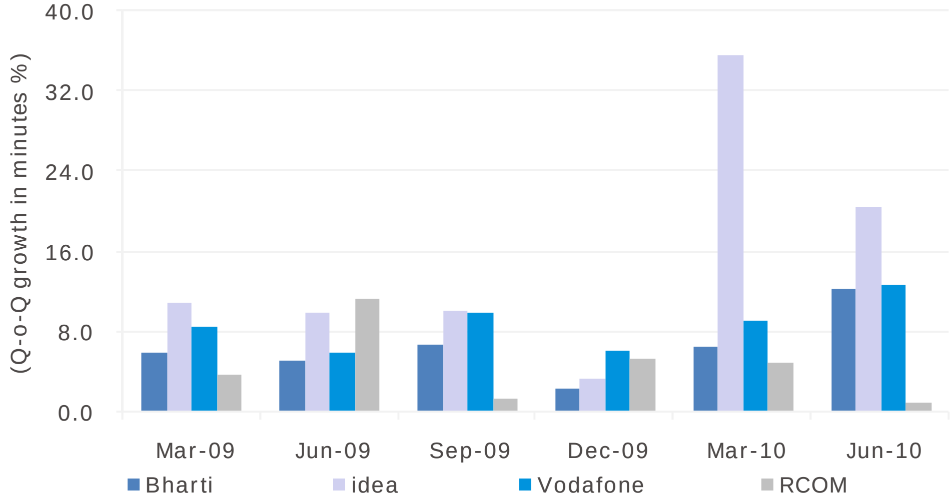
	RCOM Revenue market share (%)
Metro	
Delhi	13.1
Mumbai	16.3
Kolkata	17.4
Category A	
A. P.	8.9
Karnataka	9.1
Tamil Nadu	7.2
Maharashtra	10.4
Gujarat	9.9
Category B	
Kerala	7.1
Haryana	9.0
Punjab	6.3
U. P. (E)	12.2
U. P. (W)	9.6
Rajasthan	8.2
M. P.	20.4
West Bengal	11.6
Category C	
Assam	18.6
Bihar	15.7
H. P.	16.0
J & K	4.6
Orissa	16.0
North East	8.2

Source: TRAI

No improvement in metrics

Though RCOM re-initiated price wars in October 2009, it failed to garner market share. While its larger competitors Bharti, Vodafone, and Idea have reported improvement in metrics, the company has reported stable volumes. The company stated in Q1FY11 that the lack of volume growth was due to decline in PCO business, involuntary churning of customers, and discontinuation of free minutes offered under various schemes. It expects to report trends in line with peers Q2FY11 onwards.

Chart 1: RCOM not seeing recovery in volume (total minutes) growth



Source: Companies

Financial analysis

RCOM has been focusing on reporting 'active' subscribers and hence its reported net subscriber base could change. We expect RPM to decline to around INR 0.39, similar to Bharti and Idea. But we are assuming lower elasticity and hence MoU is likely to decline in FY11 and remain stable in FY12 due to discontinuation of free minutes and decline in the PCO business. We expect margins to remain stable at the Q1FY11 level for FY11 and for FY12 as well. We believe there is a risk to our margin assumption.

Table 2: Financial forecasts

	FY10	FY11E	FY12E	*CAGR (%)*
Consolidated financials				
Revenue (INR mn)	221,323	225,787	251,587	*6.6*
EBITDA (INR mn)	78,205	73,089	81,937	*2.4*
Net profit (INR mn)	46,550	21,203	22,868	*(29.9)*
EBITDA margin (%)	*35.3*	*32.4*	*32.6*	
Net profit margin (%)	*21.0*	*9.4*	*9.1*	
Wireless subscribers	102	129	145	*18.9*
ARPU (INR)	198	165	163	*(9.3)*
RPM (INR)	0.5	0.4	0.4	*(11.9)*
MoU	374	385	396	*3.0*
Segment-wise snapshot				
Revenues (INR mn)				
Wireless	166,397	178,518	202,774	
Global comm	83,187	75,519	78,875	
Broadband	28,385	27,862	28,904	
Net consolidated revenues	**221,323**	**225,787**	**251,587**	
EBITDA (INR mn)				
Wireless	55,981	51,838	60,833	
Global comm	17,491	14,533	15,077	
Broadband	11,474	10,309	10,695	
Net consolidated EBITDA	**78,205**	**73,089**	**81,937**	
EBITDA margin (%)				
Wireless	33.6	29.0	30.0	
Global comm	21.0	19.2	19.1	
Broadband	40.4	37.0	37.0	
Consolidated EBITDA margin	35.3	32.4	32.6	

Source: Company, Edelweiss research

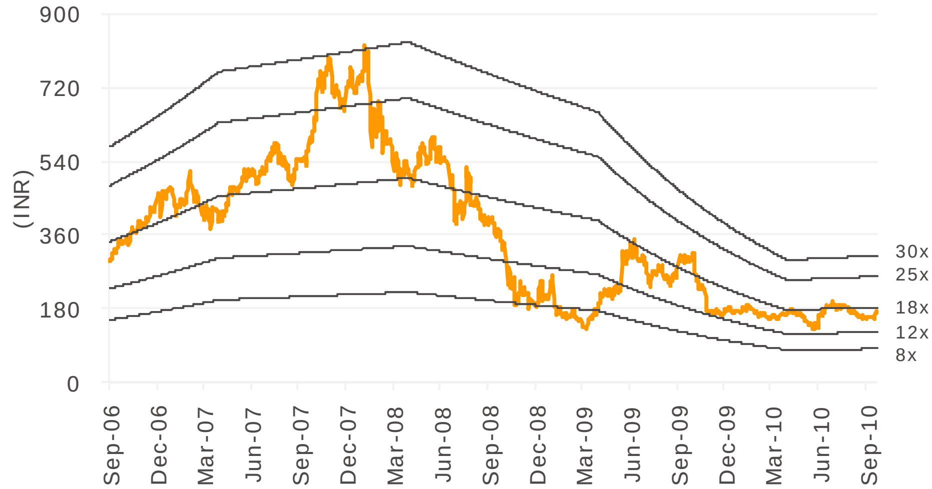
- **Outlook and valuations: Deleveraging a necessity; downgrade to 'REDUCE'**

Recent news flow has been disappointing

RCOM is carrying INR 320 bn debt on its books, which is 3.9x its expected FY11E EBITDA. Hence, it needs to deleverage. It announced two plans to raise funds by monetising its tower assets through complete sale to GTL Infra and by 26% stake sale to a strategic investor. The deal with GTL Infra has failed while the strategic investor, who was widely reported in the media, seems to be evaluating other options. The company has announced that it is in talks with other strategic / financial investors for selling stake in the tower company. We believe that stake sale in Reliance Infratel will have to be done in tranches as the quantum of funds involved will be significant for investment by the acquirer.

While deleveraging is a necessity, we believe that trigger for the stock would be improvement in metrics. The company stated in Q1FY11 results call that it will mirror industry trends in terms of total minutes growth from Q2FY11. We believe the company needs to rebuild its brand and improve market positioning to succeed in its GSM and 3G businesses. At 7.1x FY12E EV/EBITDA, it is trading at par with Bharti and Idea, which is unwarranted. We prefer Idea over RCOM due to visible improvement in metrics and its strong brand positioning, which provides it the ability to be the biggest gainer post-MNP implementation. Hence, we are downgrading our recommendation on the stock to **'REDUCE' from 'HOLD' and rate it as 'Sector Underperformer'.**

Chart 2: One year forward P/E band



Source: Bloomberg, Edelweiss research

Company Description

RCOM is the flagship company of the Reliance-ADA Group. Incorporated in July 2004, RCOM is India's leading integrated teleco, providing the entire gamut of telecom services including wireless, wireline, broadband, carrier and data services. The company commenced cellular operations in December 2002, and is India's second largest wireless operator. RCOM offers pan-India CDMA- and GSM-based wireless services. It also enjoys a strong position in the long distance and broadband segments. It operates undersea cable systems through FLAG and FALCON, connecting over 40 countries.

Investment Theme

We expect competitive intensity to increase following the implementation of MNP and launch of 3G services. RCOM, adopted a defensive 3G strategy and focused on circles where it currently has a higher market share. In our view, it should have focused on lucrative circles where it has lower market share currently as MNP would provide an opportunity to increase share in those circles. RCOM would need to invest in its brand to be able to increase market share. We believe, de-leveraging is a necessity for RCOM and the trigger for the stock would be improvement in metrics. It expects to report trends in metrics similar to its peers from Q2FY11. At current valuations, it is trading at par with its peers. Hence, we prefer Idea.

Key Risks

If RCOM is able to monetize its tower assets and sell stake to a strategic investor, it could lead to a relief rally.

Financial Statements

Income statement (INR mn)

Year to March	FY08	FY09	FY10	FY11E	FY12E
Gross revenues	229,053	276,785	289,741	296,262	329,225
Inter segment	38,380	47,369	68,419	70,475	77,638
Net revenues	190,672	229,416	221,323	225,787	251,587
Direct costs	62,590	79,408	94,561	101,022	109,524
Employee costs	12,037	16,702	15,001	15,001	15,751
Other expenses	34,055	40,429	33,556	36,675	44,376
Total operating expenses	108,683	136,539	143,117	152,698	169,650
EBITDA	81,989	92,877	78,205	73,089	81,937
Depreciation and amortisation	28,053	39,313	37,465	39,130	46,225
EBIT	53,936	53,563	40,740	33,959	35,712
Interest expenses	(3,998)	(7,867)	(11,863)	9,029	8,824
Profit before tax	57,934	61,430	52,603	24,930	26,887
Provision for tax	2,836	(123)	4,454	2,493	2,689
Core profit	55,098	61,553	48,149	22,437	24,198
Extraordinary items	12,828	(75)	(375)	0	0
Profit after tax	67,926	61,478	47,774	22,437	24,198
Minority interest	1,088	2,399	1,224	1,234	1,331
Profit after minority interest	66,838	59,079	46,550	21,203	22,868
Equity shares outstanding (mn)	2,064	2,064	2,064	2,064	2,064
EPS (INR) basic	26.2	28.7	22.7	10.3	11.1
Diluted shares (mn)	2,133	2,133	2,133	2,133	2,133
EPS (INR) fully diluted	25.3	27.7	22.0	9.9	10.7
CEPS (INR)	39.8	47.7	40.9	29.2	33.5
Dividend per share	0.7	1.0	0.8	0.8	0.8
Dividend payout (%)	3.4	4.1	4.4	9.7	9.0

Common size metrics- as % of net revenues

Year to March	FY08	FY09	FY10	FY11E	FY12E
Operating expenses	57.0	59.5	64.7	67.6	67.4
Depreciation	14.7	17.1	16.9	17.3	18.4
Interest expenditure	(2.1)	(3.4)	(5.4)	4.0	3.5
EBITDA margins	43.0	40.5	35.3	32.4	32.6
Net profit margins	28.9	26.8	21.8	9.9	9.6

Growth metrics (%)

Year to March	FY08	FY09	FY10	FY11E	FY12E
Revenues	31.8	20.3	(3.5)	2.0	11.4
EBITDA	43.3	13.3	(15.8)	(6.5)	12.1
PBT	78.0	6.0	(14.4)	(52.6)	7.9
Net profit	72.5	11.7	(21.8)	(53.4)	7.9
EPS	62.1	9.5	(20.7)	(54.8)	7.9

Balance sheet (INR mn)

As on 31st March	FY08	FY09	FY10	FY11E	FY12E
Equity capital	10,320	10,320	10,320	10,320	10,320
Reserves & surplus	279,943	412,484	429,721	448,872	469,687
Shareholders funds	290,263	422,804	440,041	459,192	480,007
Minority Interest	24,309	6,549	7,472	8,706	10,037
Secured loans	9,500	30,000	30,000	55,000	35,000
Unsecured loans	248,717	361,623	217,473	217,473	204,179
Borrowings	258,217	391,623	247,473	272,473	239,179
Sources of funds	**572,790**	**820,976**	**694,986**	**740,371**	**729,222**
Gross block	463,388	755,101	786,643	907,347	941,656
Accumulated depreciation	89,561	141,144	190,765	229,895	276,120
Net block	373,826	613,957	595,878	677,452	665,535
Capital work in progress	149,299	113,096	119,517	119,517	119,517
Total fixed assets	523,126	727,053	715,395	796,969	785,052
Goodwill	35,654	52,215	52,215	52,215	52,215
Investments	2,797	2,857	1,199	1,199	1,199
Inventories	4,059	5,427	5,446	5,446	5,446
Sundry debtors	27,224	39,618	33,380	37,639	40,186
Cash and equivalents	115,981	109,629	48,585	20,026	29,798
Loans and advances	42,695	67,557	54,826	48,461	42,095
Other current assets	23,058	17,714	21,915	21,915	21,915
Total current assets	213,017	239,945	164,152	133,487	139,441
Sundry creditors and others	156,213	159,718	198,855	206,340	211,330
Provisions	44,564	41,096	39,121	37,160	37,356
Total CL & provisions	200,776	200,814	237,976	243,500	248,686
Net current assets	12,241	39,131	(73,824)	(110,013)	(109,245)
Net deferred tax	(1,028)	(281)	0	0	0
Uses of funds	**572,790**	**820,976**	**694,986**	**740,371**	**729,222**
Book value per share (BV) (INR)	124	189	197	206	216

Free cash flow (INR mn)

Year to March	FY08	FY09	FY10	FY11E	FY12E
Net profit	67,926	61,478	47,774	22,437	24,198
Depreciation	28,053	39,313	37,465	39,130	46,225
Gross cash flow	95,979	100,792	85,240	61,568	70,424
Less: Changes in WC	(1,382)	33,242	(51,911)	(7,630)	(9,004)
Operating cash flow	97,361	67,549	137,150	69,198	79,428
Less: Capex	226,338	195,525	39,963	120,704	34,309
Free cash flow	**(128,977)**	**(127,975)**	**97,187**	**(51,506)**	**45,119**

Cash flow metrices

Year to March	FY08	FY09	FY10	FY11E	FY12E
Operating cash flow	97,361	67,549	137,150	69,198	79,428
Financing cash flow	82,119	130,991	(146,202)	22,947	(35,347)
Investing cash flow	(229,135)	(195,585)	(38,305)	(120,704)	(34,309)
Net cash flow	(49,655)	2,955	(47,357)	(28,559)	9,772
Capex	(226,338)	(195,525)	(39,963)	(120,704)	(34,309)
Dividends paid	(1,811)	(2,415)	(2,053)	(2,053)	(2,053)

Profitability & liquidity ratios

Year to March	FY08	FY09	FY10	FY11E	FY12E
ROAE (%)	20.8	16.6	10.9	4.7	4.9
ROACE (%)	11.1	7.7	5.4	4.7	4.9
Current ratio	1.1	1.2	0.7	0.5	0.6
Debtors (days)	44	53	60	57	56
Fixed assets t/o (x)	0.4	0.4	0.3	0.3	0.3
Average working capital t/o (x)	6.5	8.9	(12.8)	(2.5)	(2.3)
Debt/Equity	0.9	0.9	0.6	0.6	0.5
Debt/EBITDA	3.1	4.2	3.2	3.7	2.9
Adjusted debt/Equity	0.9	0.9	0.6	0.6	0.5

Operating ratios

Year to March	FY08	FY09	FY10	FY11E	FY12E
Total asset turnover	0.4	0.3	0.3	0.3	0.3
Fixed asset turnover	0.6	0.5	0.4	0.4	0.4
Equity turnover	0.7	0.6	0.5	0.5	0.5

Du pont analysis

Year to March	FY08	FY09	FY10	FY11E	FY12E
NP margin (%)	28.3	25.8	21.2	9.4	9.1
Total assetstTurnover	0.4	0.3	0.3	0.3	0.3
Leverage multiplier	1.9	2.0	1.8	1.6	1.6
ROE (%)	20.8	16.6	10.9	4.7	4.9

Valuation parameters

Year to March	FY08	FY09	FY10	FY11E	FY12E
Diluted EPS (INR)	25.3	27.7	22.0	9.9	10.7
Y-o-Y growth	*62.1*	*9.5*	*(20.7)*	*(54.8)*	*7.9*
CEPS (INR)	39.8	47.7	40.9	29.2	33.5
Diluted P/E (x)	6.9	6.3	8.0	17.6	16.3
Adjusted P/E (x)	5.6	6.5	8.4	19.4	17.5
Price/BV(x)	1.4	0.9	0.9	0.8	0.8
EV/Sales (x)	2.8	2.8	2.6	2.8	2.3
EV/EBITDA (x)	7.9	7.0	7.2	8.5	7.1
Dividend yield (%)	0.4	0.6	0.5	0.5	0.5

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TULIP TELECOM

Edelweiss
Ideas create, values protect

Focus on fibre

September 20, 2010

Reuters: TULP.BO Bloomberg: TTSL IN

EDELWEISS 4D RATINGS	
Absolute Rating	BUY
Rating Relative to Sector	Outperformer
Risk Rating Relative to Sector	High
Sector Relative to Market	Underweight

Note: Please refer last page of the report for rating explanation

MARKET DATA

CMP	:	INR 172
52-week range (INR)	:	214 / 158
Share in issue (mn)	:	145.0
M cap (INR bn/USD mn)	:	25 / 545
Avg. Daily Vol. BSE/NSE ('000)	:	495.2

SHARE HOLDING PATTERN (%)

Promoters*	:	69.0
MFs, FIs & Banks	:	1.3
FIIs	:	25.0
Others	:	4.7
** Promoters pledged shares (% of share in issue)*	:	*11.6*

PRICE PERFORMANCE (%)

	Stock	Nifty	EW Telecom Index
1 month	(6.1)	8.1	14.0
3 months	1.5	13.6	29.1
12 months	(15.9)	20.2	(22.1)

- **Focus on fibre: Favorable for margins, de-leverages business risk**

  Earlier limited to wireless IP VPN services, Tulip Telecom (TTSL) foray into the fibre business has not only increased its addressable market by ~5.5x to ~INR 75 bn, but also has helped partially de-risk its business model which was earlier entirely dependent on the IP VPN segment growth. TTSL is seeing strong uptick in its fibre business with ~600 customers on-board, Q1FY11 revenue contribution at 25% (versus negligible revenues in early FY10). ~70% of the contracts are fresh deals versus wireless-to-fibre substitution, which implies that the company has had some initial success despite breaching the turf of established telecos. However, falling bandwidth prices remain a key risk in a closely competitive market.

- **Revenue mix now dominated by steady annuity revenues**

  The revenue mix for TTSL's IP VPN business, its key growth and profitability driver, has changed considerably with rising proportion of annual recurring revenues estimated at a significant 78% in FY10 vis-à-vis one-time installation revenues which dominated the revenue mix initially (in FY07 at >50%). We estimate the company enterprise connectivity revenues (including fibre and IP VPN segments) to post ~19% CAGR over FY11-12E to ~INR 24 bn with recurring revenues at ~82-85% of the IP VPN revenues.

- **Government projects on the radar again, but for data connectivity**

  TTSL has revived its focus on government projects, albeit this time around for data connectivity and managed services, versus earlier role of pure network integration in SWAN projects. It recently won three such contracts under the R-APDRP projects, totaling ~INR 1.7 bn. While the project sizes are too small to materially impact TTSL's earnings, management highlighted that infrastructure could be leveraged for other government projects as well in future, which could be a material benefit for the company.

- **Outlook and valuations: Attractive; maintain 'BUY'**

  We remain positive on TTSL's core business growth given its wide IP VPN network footprint and rapidly expanding fibre network presence. We are tweaking our FY11-12 revenue estimates upwards by ~3-4% led by higher enterprise connectivity revenues, which has led to a ~5-7% lift in our FY11-12 earnings estimates. Current stock valuations (P/E of 9.1x and 8.2x FY11E and FY12E, respectively) are attractive and likely reflect most of the investor concerns on rising competition and potential price cuts (particularly with entry of BWA players). We maintain **'BUY / Sector Outperformer'** recommendation/rating.

Financials

Year to March	FY09	FY10	FY11E	FY12E
Revenue (INR mn)	16,144	19,664	22,703	25,621
Rev. growth (%)	*32.7*	*21.8*	*15.5*	*12.9*
EBIDTA (INR mn)	3,367	5,255	6,366	7,245
Adj. net profit (INR mn)	2,023	2,611	3,061	3,419
Diluted EPS (INR)	12.5	16.1	18.9	21.1
EPS growth (%)	*8.2*	*29.1*	*17.2*	*11.7*
Diluted P/E (x)	13.8	10.7	9.1	8.2
EV/ EBITDA	9.7	6.4	5.3	4.6
ROAE (%)	30.9	29.0	27.1	24.8
ROACE (%)	18.8	19.7	22.1	23.0

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Addressable market has increased 5.5x to INR 75 bn with entry into the fibre business

■ Focus on fibre: Favorable for margins, de-leverages business risk

TTSL's fibre business is gaining rapid traction since its launch 18 months ago. Earlier limited to wireless IP VPN services, the company's foray into the fibre business has helped it to tap into the higher bandwidth enterprise connectivity market requirements. This segment was earlier largely inaccessible on its wireless medium, especially in tier 1 cities and towns where fibre connectivity is widely available, besides corporates' preference for physical links versus wireless links for primary connectivity. Thus, with entry into the fibre business, TTSL's addressable market has increased by ~5.5x to ~INR 75 bn.

Chart 1: 2010 Enterprise data market at INR 75 bn

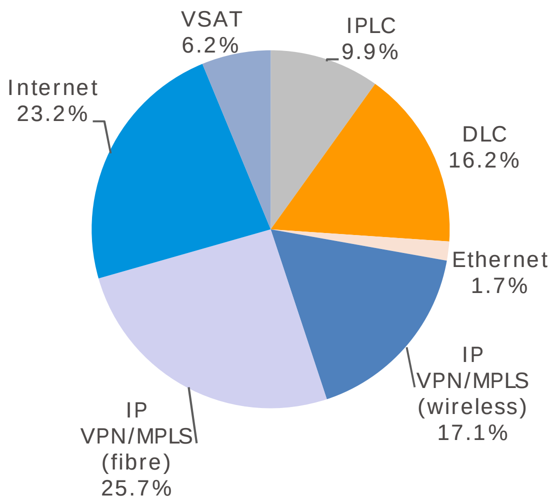
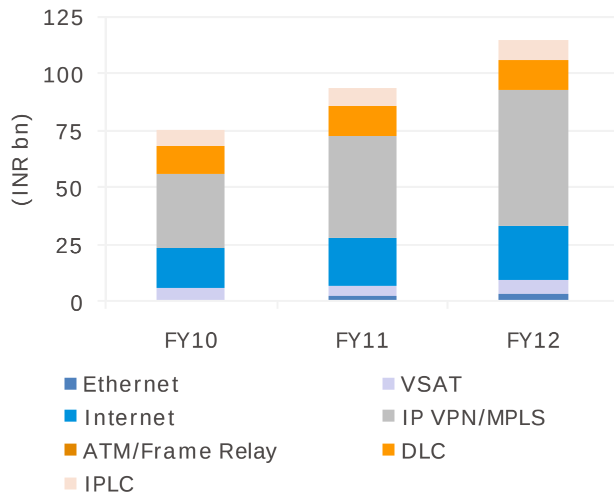


Chart 2: 2012 Enterprise data market at INR 114 bn



Source: Company

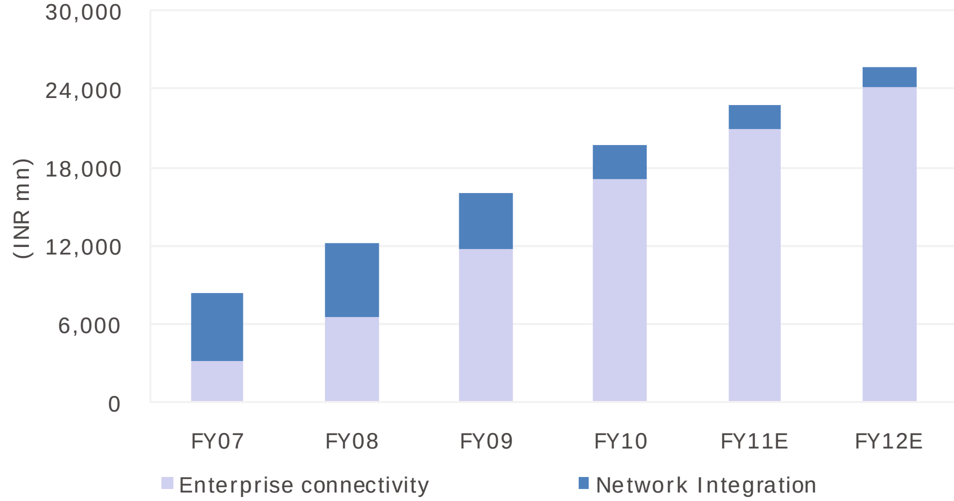
TTSL's fibre network of ~6000km currently spans across 50+ cities, with initial presence in CBDs of 250 cities. The company is seeing strong uptick in its fibre business with ~600 customers on-board and Q1FY11 revenue contribution at ~25% (versus negligible revenues in early FY10). ~70% of the contracts are fresh deals versus wireless-to-fibre substitution, which implies that TTSL has had some initial success despite breaching the turf of established telecos.

Fibre business provides scope for margin expansion and strong jump in ARPUs

Besides market size expansion, we believe entry into the fibre business has helped partially de-risk its business model which was earlier entirely dependent on the IP VPN segment growth. We understand that ARPU from the fibre business, depending on the bandwidth speed offered, can grow manifold (vis-à-vis the current IP VPN ARPUs) and this business yields relatively higher EBITDA margin vis-à-vis TTSL's own IP VPN business. We reckon that as a nascent operator, TTSL has considerable scope to garner volume growth and improve its market share in this segment.

We estimate the company enterprise connectivity revenues (including fibre and IP VPN segments) to post ~19% CAGR over FY11-12 to ~INR 24 bn and expect fibre business revenue share at ~35% by FY12. However, falling bandwidth prices remain a key risk in a closely competitive market for enterprise connectivity services.

Chart 3: TTSL's FY07-12E revenue snapshot



Source: Company, Edelweiss research

**FY10 revenue-breakup is estimated*

Enterprise connectivity revenues (including fibre and IP VPN segments) to post ~19% CAGR over FY11-12E to ~INR 24 bn

- **IP VPN business provides steady annuity revenues**

TTSL's IP VPN business has been the key driver of its revenue growth and profitability since FY07 led by strong connects growth and relatively stable ARPUs. Over FY07-10, IP VPN revenues posted an estimated ~69% CAGR led by 78% CAGR in connects. The segment's revenue mix has changed considerably with with rising proportion of annual recurring revenues estimated at a significant 78% in FY10 vis-à-vis one-time installation revenues which dominated the revenue mix initially (in FY07 at >50%). We believe this is a material positive as it implies stable and consistent cash flows from the business given an annuity revenue stream. Going forward we estimate recurring revenues at ~82-85% of the IP VPN revenues.

Chart 4: Rapid IP VPN connects growth…

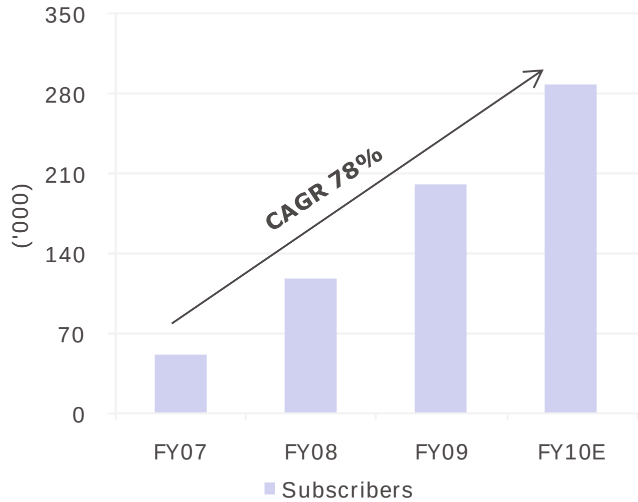
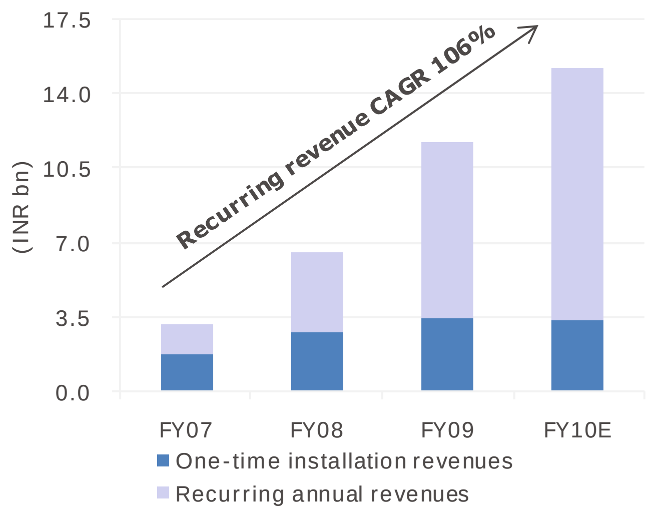


Chart 5: …has driven revenue CAGR of 69%



Source: Company, Edelweiss research

*Note: *FY10 revenue-breakup is estimated*

Government projects on the radar again, but for data connectivity

The company has again revived its focus on government projects, albeit this time around for data connectivity and managed services, versus earlier role of pure network integration in SWAN projects. TTSL recently won three contracts for providing data connectivity services under the R-APDRP projects in UP, Gujarat and Uttarkhand, totaling INR 1.7 bn. These projects are to be executed over the next 12-18 months with nominal capex and will be maintained over a period of 3-5 years by TTSL. Revenues for these projects will flow in in 20 quarterly investments over 5 years. Assuming revenues commencing FY12 onwards, this will comprise a nominal <2% of FY12E revenues.

Management has stated that it perceives opportunity in such data connectivity projects for the government and we reckon the company is aggressively bidding for more projects in this space. However, while we view this development as positive given the higher profitability (EBITDA margin for these projects to be higher than its current blended margin of ~26.7%), we believe the project sizes are too small to materially impact TTSL's earnings. However, management highlighted that the projects' infrastructure could be leveraged for other government projects as well in future, which could be a material benefit for the company.

BWA JV with Qualcomm likely a financial investment

In July 2010, TTSL acquired 13% minority stake in a BWA JV with Qualcomm for INR 1.4 bn. Another 13% was sold by Qualcomm to Global Holdings Corporation. Qualcomm holds BWA licences for four circles in India including metro circles of Mumbai and Delhi, besides Kerala and Haryana, for which it paid a total licence fee of ~INR 49 bn. The JV's EV is pegged at USD 1.1 bn (equivalent to value of BWA licences) with debt of USD 888 mn.

Management highlighted that the JV is likely to further rope in 1-2 telecom operators who will drive the rollout of BWA services with Qualcomm being the technology facilitator for deployment of LTE. It indicated that rollout of services is atleast 12-18 months away (likely end-CY11) and that the JV will cater to the retail segment (B2C).

Table 1: BWA JV licence details

Circles	Category	Licence fee paid (INR bn)
Mumbai	A	22.9
Delhi	A	22.4
Kerala	B	2.6
Haryana	B	1.2

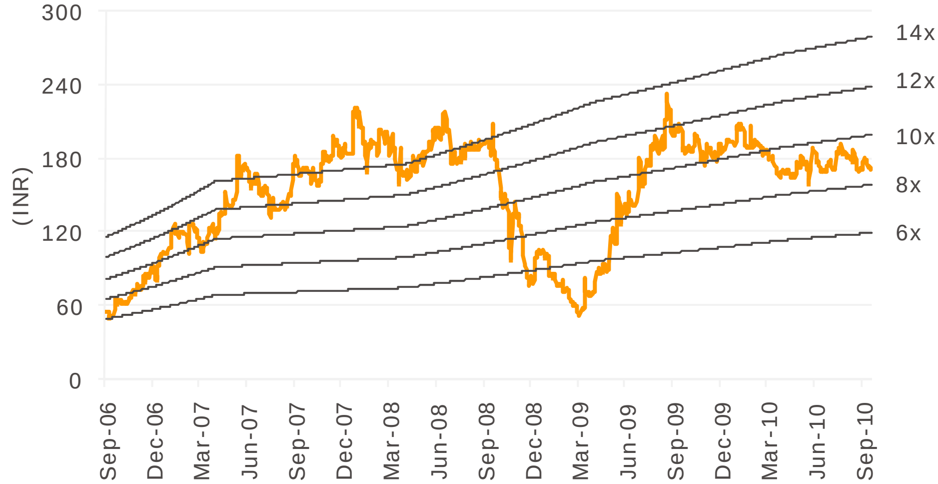
Source: DoT

We view TTSL's investment in this JV as more of a financial investment given the size of its stake and the JV's focus on the retail segment versus TTSL's focus exclusively on enterprise connectivity. TTSL's management has also stated that neither is there any recourse to TTSL regarding the JV's debt, nor will there be any additional investments in this JV. However, the deal provides some comfort factor to investors that as a JV partner TTSL will be able to provide BWA services should it enterprise customers require them. Given that there is no lock-in period for this investment for TTSL, we reckon that the company may monetise this investment in the future.

Outlook and valuations: Attractive, maintain **'BUY'**

We remain positive on TTSL's core business growth given its wide IP VPN network footprint and expanding fibre network presence. We are tweaking our FY11-12 revenue estimates upwards by ~3-4% led by higher enterprise connectivity revenues, which has led to a 5-7% lift in our FY11-12 earnings estimates. Current stock valuations (P/E of 9.1x and 8.2x and EV/EBITDA of 5.3x and 4.6x FY11E and FY12E, respectively) likely reflect most of the investor concerns on rising competition and potential price cuts (particularly with entry of BWA players). We maintain '**BUY'** on the stock and rate it '**Sector Outperformer'** on relative returns basis.

Chart 6: One year forward P/E band



Source: Bloomberg, Edelweiss research

Company Description

TTSL's principle business entails providing enterprise connectivity services through wireless and fibre last mile network. It provides intercity and intra-city wireless IP VPN connectivity to enterprises in over 1500 locations. In the last 18 months, TTSL has also rolled out its own fibre network of ~6000 km spanning 50+ cities, with initial presence in CBDs of ~250 cities. TTSL has also entered the ILD segment and is setting up six international PoPs. It has also received the FCC 214 licence which will enable it to sell data connectivity services in the US. Besides enterprise connectivity, TTSL provides network integration and management services as well. In July 2010, TTSL acquired a 13% minority stake in a BWA JV with Qualcomm for INR 1.4 bn.

Investment Theme

We are positive on TTSL's business prospects as an integrated provider of network equipment and connectivity for enterprises. With a wide network footprint covering urban & rural areas, we see continued traction in the IP VPN business driving revenue growth and profitability for TTSL. The rollout of fibre network is expected to materially enhance TTSL's addressable market and ability to compete for high bandwidth customers, thereby leading to higher realizations and better profitability.

Key Risks

Competition from larger integrated telecos like Bharti Airtel, Reliance Communications, and BSNL is the key risk for TTSL. With the SME segment (currently the key market for TTSL) being considered as a lucrative opportunity by large players, added competitive pressure may increase the risk quotient for TTSL. Also, the emergence of new cost-effective and more efficient technologies may impact TTSL's business, as adopting new technologies or switching over to new service offerings may require significant capex that may not be viable for TTSL.

Financial Statements

Income statement **(INR mn)**

Year to March	FY08	FY09	FY10	FY11E	FY12E
Net revenues	12,163	16,144	19,664	22,703	25,621
Direct costs	8,981	11,511	12,953	14,341	16,196
Employee costs	396	712	817	898	986
Other expenses	330	554	639	1,098	1,193
Total operating expenses	9,708	12,777	14,409	16,337	18,376
EBITDA	2,455	3,367	5,255	6,366	7,245
Depreciation and amortisation	418	414	1,353	1,649	2,112
EBIT	2,037	2,953	3,902	4,717	5,133
Interest expenses	258	462	716	753	633
Other income	230	(386)	250	117	58
Profit before tax	2,009	2,105	3,436	4,081	4,558
Provision for tax	139	81	825	1,020	1,140
Core profit	1,870	2,023	2,611	3,061	3,419
Extraordinary items	0	475	132	-	-
Profit after tax	1,870	2,498	2,743	3,061	3,419
Equity shares outstanding (mn)	145.0	145.0	145.0	145.0	145.0
EPS (INR) basic	12.9	14.0	18.0	21.1	23.6
Diluted shares (mn)	162.2	162.2	162.2	162.2	162.2
EPS (INR) fully diluted	11.5	12.5	16.1	18.9	21.1
CEPS (INR)	13.5	14.9	25.4	30.5	36.2
Dividend per share	0.4	0.8	1.6	1.6	1.6
Dividend payout (%)	3.6	5.4	9.9	8.9	7.9

Common size metrics- as % of net revenues

Year to March	FY08	FY09	FY10	FY11E	FY12E
Operating expenses	79.8	79.1	73.3	72.0	71.7
Depreciation	3.4	2.6	6.9	7.3	8.2
Interest expenditure	2.1	2.9	3.6	3.3	2.5
EBITDA margins	20.2	20.9	26.7	28.0	28.3
Net profit margins	15.4	12.5	13.3	13.5	13.3

Growth metrics (%)

Year to March	FY08	FY09	FY10	FY11E	FY12E
Revenues	44.7	32.7	21.8	15.5	12.9
EBITDA	83.3	37.2	56.1	21.1	13.8
PBT	93.0	4.8	63.3	18.8	11.7
Net profit	97.7	8.2	29.1	17.2	11.7
EPS	76.7	8.2	29.1	17.2	11.7

Balance sheet (INR mn)

As on 31st March	FY08	FY09	FY10	FY11E	FY12E
Equity capital	290	290	290	290	290
Reserves & surplus	4,164	6,529	8,989	10,932	13,798
Shareholders funds	4,454	6,819	9,279	11,222	14,088
Secured loans	1,943	5,141	5,476	6,743	5,746
Unsecured loans	6,996	6,083	6,715	4,647	4,929
Borrowings	8,938	11,224	12,191	11,390	10,675
Sources of funds	**13,392**	**18,044**	**21,470**	**22,612**	**24,762**
Gross block	4,447	9,437	14,502	20,207	24,254
Accumulated Depreciation	647	1,061	2,414	4,062	6,174
Net block	3,799	8,376	12,088	16,145	18,080
Capital work in progress	1,398	3,772	1,209	-	-
Total fixed assets	5,197	12,148	13,296	16,145	18,080
Investments	-	-	-	1,400	1,400
Inventories	702	916	688	762	861
Sundry debtors	2,006	3,242	5,320	5,598	6,317
Cash and equivalents	5,938	3,470	3,470	1,204	1,112
Loans and advances	287	1,093	1,559	1,799	2,031
Total current assets	8,932	8,722	11,037	9,363	10,321
Sundry creditors and others	532	2,363	2,117	2,650	2,992
Provisions	197	458	721	1,620	2,021
Total CL & provisions	729	2,821	2,838	4,270	5,013
Net current assets	8,203	5,901	8,199	5,093	5,308
Net deferred tax	(9)	(9)	(29)	(29)	(29)
Misc expenses not w/o	1	4	4	4	4
Uses of funds	**13,392**	**18,044**	**21,470**	**22,612**	**24,762**
Book value per share (BV) (INR)	31	47	64	77	97

Free cash flow (INR mn)

Year to March	FY08	FY09	FY10	FY11E	FY12E
Net profit	1,870	2,498	2,743	3,061	3,419
Depreciation	418	414	1,353	1,649	2,112
Others	(68)	4	12	-	(0)
Gross cash flow	2,220	2,916	4,109	4,709	5,531
Less: Changes in W. C.	908	166	2,298	(275)	306
Operating cash flow	1,312	2,750	1,811	4,985	5,224
Less: Capex	3,118	7,365	4,786	4,497	4,047
Free cash flow	**(1,806)**	**(4,615)**	**(2,975)**	**488**	**1,177**

Cash flow metrices (INR mn)

Year to March	FY08	FY09	FY10	FY11E	FY12E
Operating cash flow	1,312	2,750	1,811	4,985	5,224
Financing cash flow	7,454	2,063	695	(1,354)	(1,269)
Investing cash flow	(3,118)	(7,365)	(4,786)	(5,897)	(4,047)
Net cash flow	5,648	(2,552)	(2,280)	(2,266)	(91)
Capex	(3,118)	(7,365)	(4,786)	(4,497)	(4,047)
Dividends paid	(68)	(136)	(271)	(271)	(271)

Profitability & liquidity ratios

Year to March	FY08	FY09	FY10	FY11E	FY12E
ROAE (%)	42.4	30.9	29.0	27.1	24.8
ROACE (%)	23.1	18.8	19.7	22.1	23.0
Current ratio	12.3	3.1	3.9	2.2	2.1
Debtors (days)	51	59	79	88	85
Fixed assets t/o (x)	3.2	1.9	1.5	1.5	1.5
Average working capital t/o (x)	2.5	2.3	2.8	3.4	4.9
Debt/Equity	2.0	1.6	1.3	1.0	0.8
Debt/EBITDA	3.6	3.3	2.3	1.8	1.5
Adjusted debt/Equity	2.0	1.6	1.3	1.0	0.8

Operating ratios

Year to March	FY08	FY09	FY10	FY11E	FY12E
Total asset turnover	1.4	1.0	1.0	1.0	1.1
Fixed asset turnover	3.9	2.7	1.9	1.6	1.5
Equity turnover	3.4	2.9	2.4	2.2	2.0

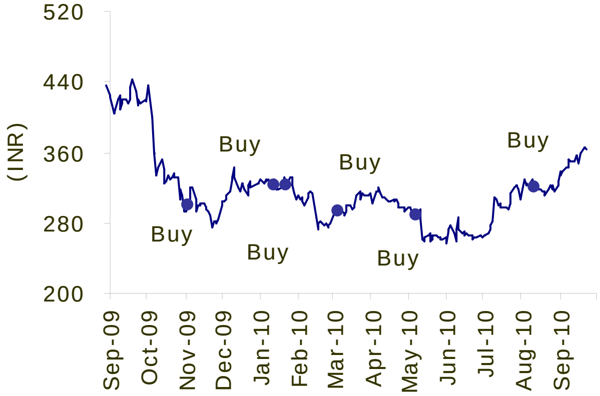
Du pont analysis

Year to March	FY08	FY09	FY10	FY11E	FY12E
NP margin (%)	12.6	10.8	11.8	12.2	12.2
Total assets turnover	1.4	1.0	1.0	1.0	1.1
Leverage multiplier	2.4	2.8	2.5	2.2	1.9
ROAE (%)	42.4	30.9	29.0	27.1	24.8

Valuations parameters

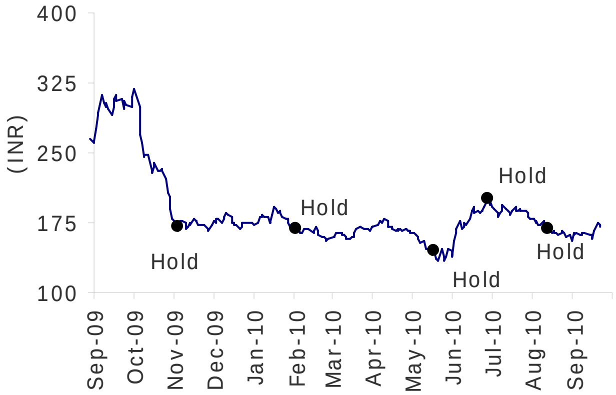
Year to March	FY08	FY09	FY10	FY11E	FY12E
Diluted EPS (INR)	11.5	12.5	16.1	18.9	21.1
Y-o-Y growth	*76.7*	*8.2*	*29.1*	*17.2*	*11.7*
CEPS (INR)	13.5	14.9	25.4	30.5	36.2
Diluted P/E (x)	14.9	13.8	10.7	9.1	8.2
Price/BV(x)	5.6	3.7	2.7	2.2	1.8
EV/Sales (x)	2.3	2.0	1.7	1.5	1.3
EV/EBITDA (x)	11.4	9.7	6.4	5.3	4.6
Dividend yield (%)	0.2	0.5	0.9	0.9	0.9

Bharti Airtel



Idea Cellular

Reliance Communication



Tulip Telecom

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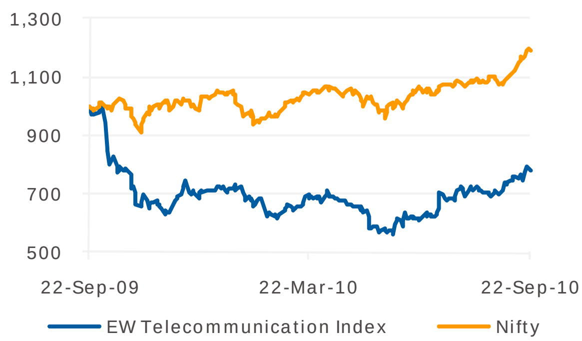
EW indices



Recent Research

Date	Company	Title	Price (INR)	Recos
18-May-10	**Reliance Comm.**	Tepid quarter; outlook; remains cautious; *Result Update*	142	Hold
17-May-10	**Telecom**	Reprieve for incumbents Likely; *Sector Update*		
7-May-10	**Bharti Airtel**	In-line performance; *Result Update*	287	Buy
7-May-10	**Idea Cellular**	Healthy quarter; outlook remains cautious; *Result Update*	63	Hold

Distribution of Ratings / Market Cap

Edelweiss Research Coverage Universe

	Buy	Hold	Reduce	Total
Rating Distribution*	116	45	12	176

* 3 stocks under review

	> 50bn	Between 10bn and 50 bn	< 10bn
Market Cap (INR)	110	53	13

Rating Interpretation

Rating	Expected to
Buy	appreciate more than 15% over a 12-month period
Hold	appreciate up to 15% over a 12-month period
Reduce	depreciate more than 5% over a 12-month period

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