

## Reliance Communications

RCOM IN

1 Buy  
2 Outperform  
3 Hold  
4 Underperform (unchanged)  
5 Sell

Target price: **Rs79.00** → **Rs65.00**

Up/downside: **-16.2%**

Share price (29 Sep): **Rs77.60**

# We see no way out of the debt burden yet

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- We have cut our EPS forecasts by 14-18% for FY12-14
- Maintain Underperform; shares not yet worth revisiting
- Ongoing news flow on 2G spectrum controversy could be a key overhang

#### ■ What's new

We have reviewed Reliance Communications' (RCOM) outlook in light of: 1) the recent release of its FY11 audited financial statements, and 2) news flow that the Central Bureau of Investigation (CBI) is investigating the role of RCOM's chairman in the 2G spectrum controversy.

#### ■ What's the impact

We have revised down our EPS forecasts for FY12-14 by 14-18% due to our forecasts for lower revenue and higher interest expenses.

While the pace and magnitude of any fallout from the CBI's investigations is very unclear, we believe this news is negative as it would consume management resources and probably dilute its focus on the core business.

RCOM has already been losing mobile-revenue share and we think this trend is likely to worsen. We

forecast its mobile-revenue share to decline by 2.2pp over FY11-14.

Our downward revenue-forecast revisions also take into account a more subdued outlook for the global enterprise segment – which includes sales of fibre capacity for Europe and US customers – due to global economic growth concerns.

RCOM's 3G strategy also raises some questions. Its TV commercials for 3G emphasise mobile TV and video-calling services, which we think is a suboptimal way to use limited 3G spectrum resources and could compromise the user experience.

Our review of the group's annual report suggests that its audited debt figures were slightly higher than those shown in the 4Q FY11 report. We have revised up our interest-expense forecasts for RCOM for FY12-14, partly to account for this higher-than-expected debt burden.

Most of the foreign-currency debt on RCOM's books (69% of its total debt of Rs391bn at the end of FY11) is unhedged. Given the 10% quarter-to-date depreciation of the Rupee (vs. the US Dollar), we estimate a potential Rs26.4bn impact via mark-to-market or translational losses. This is not in our forecasts, as we are not sure what proportion of these losses would flow through the P&L and balance sheet.

#### ■ What we recommend

We have lowered our DCF-based six-month target price to Rs65 (from Rs79) on our downward forecast revisions. We maintain our Underperform (4) rating on the stock. A key upside risk to our target price would be a potential tower sale.

RCOM's share-price performance is currently driven by news flow

related to the ongoing 2G spectrum controversy. As this may dilute management's focus on operations and possibly affect the prospects of planned tower sales, we think it could be a key overhang for the stock.

#### ■ How we differ

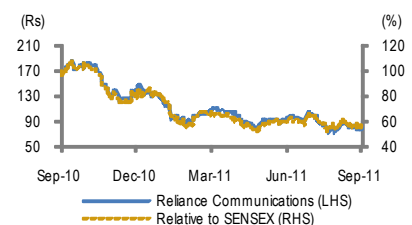
Our FY12-13 EPS forecasts are 24-37% below those of the Bloomberg consensus as we are less optimistic about a turnaround in the operational performance.

#### Forecast revisions (%)

Year to 31 Mar	12E	13E	14E
Revenue change	(6.3)	(7.9)	(9.5)
Net-profit change	(15.4)	(14.3)	(17.8)
EPS change	(15.4)	(14.3)	(17.8)

Source: Daiwa forecasts

#### Share price performance



12-month range	72.20-187.10
Market cap (US\$bn)	3.27
Average daily turnover (US\$m)	18.80
Shares outstanding (m)	2,064
Major shareholder	AAA Communications (54.2%)

#### Financial summary (Rs)

Year to 31 Mar	12E	13E	14E
Revenue (m)	206,145	213,765	222,005
Operating profit (m)	19,188	21,232	23,410
Net profit (m)	8,177	9,992	9,471
Core EPS	3.962	4.841	4.589
EPS change (%)	(47.7)	22.2	(5.2)
Daiwa vs Cons. EPS (%)	(24)	(37)	(54)
PER (x)	19.6	16.0	16.9
Dividend yield (%)	0.6	0.6	0.6
DPS	0.500	0.500	0.500
PBR (x)	0.4	0.4	0.4
EV/EBITDA (x)	7.1	6.3	5.5
ROE (%)	2.0	2.4	2.2

Source: Bloomberg, Daiwa forecasts

## Revisions to forecasts

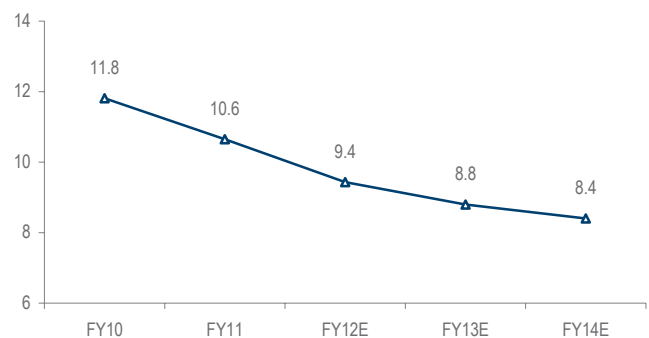
Our 14-18% downward revisions to our net-profit forecasts for RCOM for FY12-14 are driven by: 1) 6-9.5% downward revisions to our revenue forecasts, 2) 3-4% downward revisions to our D&A forecasts on a lower capex outlook (we have revised down our FY12E capex/sales ratio from 13% to 12%) as we think the company is likely to conserve cash, and 3) 4-7% upward revisions to our forecasts for interest expenses on a higher-than-expected debt burden according to the audited FY11 annual report. As a result, we have lowered our DCF-derived six-month target price by 18% to Rs65.

### RCOM: revisions to key financial forecasts

(%)	FY12E	FY13E	FY14E
Revenue	(6)	(8)	(9)
Mobile	(3)	(4)	(4)
Non-mobile	(3)	(7)	(10)
EBITDA	(4)	(5)	(6)
D&A	(3)	(3)	(4)
EBIT	(6)	(8)	(10)
Interest expense	7	6	4
Net profit	(15)	(14)	(18)
<b>Mobile-revenue drivers</b>			
Subscribers	(22)	(16)	(16)
ARPU	(1)	1	2
Operating cash flow	3	(3)	(5)
Capex	(6)	(15)	(16)

Source: Daiwa forecasts

### RCOM: mobile-revenue share (%)

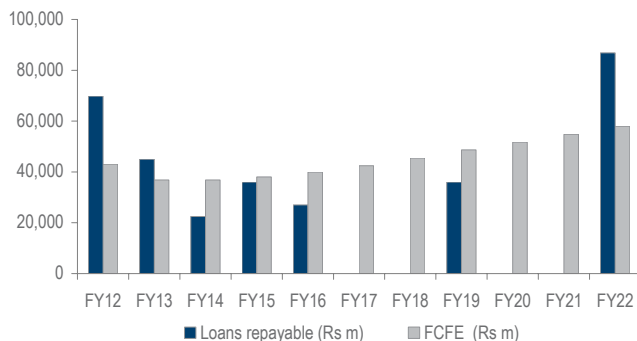


Source: Company, Daiwa

## Debt outlook

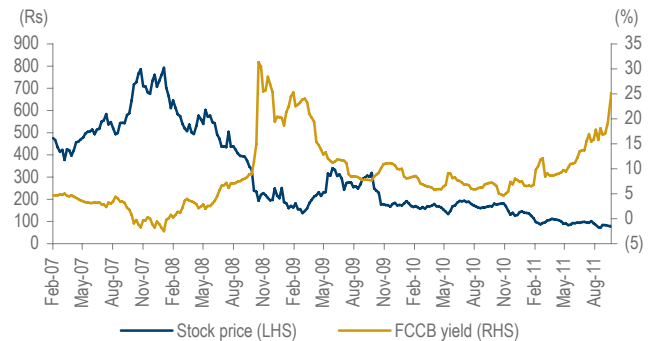
The yields on RCOM's foreign currency convertible bonds (FCCBs), which are due for redemption in February 2012, have risen sharply in recent weeks and reached 26%. This is due mainly to: 1) its lacklustre operational performance, 2) concerns about its high debt, and 3) news flow related to the 2G controversy. The FCCB yields touched 31% during the 2008 global financial crisis. The sharp rise in the FCCB yields over the past few weeks raises questions about whether RCOM would be able to repay its bondholders in the current economic climate. On our forecasts, even though FY12E free cash flow is slightly below the debt due, we believe RCOM should be able to redeem the FCCBs, by refinancing some of its existing debt. The unfolding events relating to the 2G spectrum controversy are a key risk as we are unable to ascertain its impact on RCOM.

### RCOM: ECB repayment schedule versus FCFE



Source: RBI, Daiwa

### RCOM: share price and FCCB yield movement



Source: Bloomberg

**Financial summary**
**■ Key assumptions**

Year to 31 Mar	2007	2008	2009	2010	2011	2012E	2013E	2014E
Total mobile subs (m)	28.97	45.79	72.67	102.42	135.72	158.52	180.18	199.68
Subscriber net add (m)	14.29	16.83	26.87	29.76	33.30	22.80	21.66	19.50
Total usage (bn min)	175	206	277	350	375	412	451	490
MOU per sub (min)	475	458	389	333	262	233	222	215
Blended ARPU (Local curr.)	348.3	339.2	244.4	158.4	116.0	97.4	87.7	80.7
Data as % of total ARPU	6.2%	6.5%	7.3%	7.7%	8.0%	9.0%	10.0%	10.0%

**■ Profit and loss (Rs m)**

Year to 31 Mar	2007	2008	2009	2010	2011	2012E	2013E	2014E
Wireless	128,479	152,135	173,677	166,396	165,762	172,040	178,233	183,900
Global	65,922	54,750	67,761	83,187	100,519	72,840	74,875	78,196
Others	(19,999)	(16,562)	(16,098)	(30,357)	(35,205)	(38,735)	(39,342)	(40,091)
<b>Total revenue</b>	<b>174,403</b>	<b>190,323</b>	<b>225,340</b>	<b>219,226</b>	<b>231,076</b>	<b>206,145</b>	<b>213,765</b>	<b>222,005</b>
Other income	0	0	0	0	0	0	0	0
COGS	(68,077)	(62,591)	(79,845)	(92,783)	(92,764)	(95,228)	(97,641)	(100,018)
SG&A	(27,772)	(34,059)	(38,599)	(35,328)	(32,740)	(30,922)	(32,065)	(33,301)
Other op. expenses	(40,481)	(39,928)	(52,805)	(52,466)	(79,795)	(60,807)	(15,495)	(16,270)
<b>Operating profit</b>	<b>38,073</b>	<b>53,746</b>	<b>54,092</b>	<b>38,649</b>	<b>25,777</b>	<b>19,188</b>	<b>21,232</b>	<b>23,410</b>
Net-interest inc./(exp.)	(1,487)	128	(9,725)	(12,491)	(8,418)	(8,624)	(7,194)	(8,963)
Assoc/forex/extraord./others	(595)	16,874	17,616	26,044	(2,282)	0	0	0
<b>Pre-tax profit</b>	<b>35,991</b>	<b>70,747</b>	<b>61,983</b>	<b>52,202</b>	<b>15,077</b>	<b>10,563</b>	<b>14,037</b>	<b>14,448</b>
Tax	(731)	(2,836)	518	(4,454)	(118)	(1,268)	(2,807)	(3,612)
Min. int./pref. div./others	49	(13,901)	(2,052)	(1,193)	(1,503)	(1,119)	(1,238)	(1,365)
<b>Net profit (reported)</b>	<b>35,309</b>	<b>54,011</b>	<b>60,449</b>	<b>46,556</b>	<b>13,457</b>	<b>8,177</b>	<b>9,992</b>	<b>9,471</b>
<b>Net profit (adjusted)</b>	<b>35,899</b>	<b>37,122</b>	<b>42,850</b>	<b>20,480</b>	<b>15,640</b>	<b>8,177</b>	<b>9,992</b>	<b>9,471</b>
<b>EPS (reported) (Rs)</b>	<b>17.269</b>	<b>26.291</b>	<b>29.287</b>	<b>22.556</b>	<b>6.520</b>	<b>3.962</b>	<b>4.841</b>	<b>4.589</b>
<b>EPS (adjusted) (Rs)</b>	<b>17.558</b>	<b>18.070</b>	<b>20.760</b>	<b>9.922</b>	<b>7.577</b>	<b>3.962</b>	<b>4.841</b>	<b>4.589</b>
<b>EPS (adjusted fully-diluted) (Rs)</b>	<b>17.558</b>	<b>18.070</b>	<b>20.760</b>	<b>9.922</b>	<b>7.577</b>	<b>3.962</b>	<b>4.841</b>	<b>4.589</b>
<b>DPS (Rs)</b>	<b>0.500</b>	<b>0.754</b>	<b>0.800</b>	<b>0.850</b>	<b>0.500</b>	<b>0.500</b>	<b>0.500</b>	<b>0.500</b>
<b>EBIT</b>	<b>38,073</b>	<b>53,746</b>	<b>54,092</b>	<b>38,649</b>	<b>25,777</b>	<b>19,188</b>	<b>21,232</b>	<b>23,410</b>
<b>EBITDA</b>	<b>67,266</b>	<b>81,798</b>	<b>90,169</b>	<b>76,114</b>	<b>90,816</b>	<b>65,238</b>	<b>68,564</b>	<b>72,416</b>

**■ Cash flow (Rs m)**

Year to 31 Mar	2007	2008	2009	2010	2011	2012E	2013E	2014E
Profit before tax	34,903	83,429	77,693	51,859	15,297	10,563	14,037	14,448
Depreciation and amortisation	29,193	28,053	36,077	37,465	65,038	46,050	47,333	49,006
Tax paid	(1,153)	(2,160)	(3,926)	(3,122)	(791)	(2,113)	(2,807)	(3,612)
Change in working capital	63,409	(35,837)	(21,519)	25,293	(60,470)	2,846	2,679	2,281
Other operational CF items	2,212	(29,019)	(23,250)	(15,851)	4,782	8,709	8,439	10,309
<b>Cash flow from operations</b>	<b>128,564</b>	<b>44,465</b>	<b>65,075</b>	<b>95,645</b>	<b>23,855</b>	<b>66,055</b>	<b>69,680</b>	<b>72,432</b>
Capex	(52,488)	(173,928)	(122,426)	(74,959)	(101,208)	(14,430)	(25,652)	(26,641)
Net (acquisitions)/disposals	(54,436)	(29,791)	15,567	54,884	36,472	4,525	0	0
Other investing CF items	6,550	7,764	6,779	1,689	158	0	0	0
<b>Cash flow from investing</b>	<b>(100,374)</b>	<b>(195,955)</b>	<b>(100,079)</b>	<b>(18,387)</b>	<b>(64,579)</b>	<b>(9,905)</b>	<b>(25,652)</b>	<b>(26,641)</b>
Change in debt	24,878	100,745	75,084	(69,898)	96,356	(68,906)	0	0
Net share issues/(repurchases)	0	0	0	0	0	0	0	0
Dividends paid	0	(1,183)	(1,792)	(1,911)	(2,025)	(1,207)	(1,207)	(1,207)
Other financing CF items	(6,535)	(10,227)	(30,861)	(14,408)	(13,624)	(8,624)	(7,194)	(8,963)
<b>Cash flow from financing</b>	<b>18,342</b>	<b>89,335</b>	<b>42,431</b>	<b>(86,217)</b>	<b>80,707</b>	<b>(78,738)</b>	<b>(8,402)</b>	<b>(10,170)</b>
Forex effect/others	(44)	(1,071)	620	316	0	0	0	0
<b>Change in cash</b>	<b>46,489</b>	<b>(63,225)</b>	<b>8,047</b>	<b>(8,644)</b>	<b>40,478</b>	<b>(22,591)</b>	<b>35,627</b>	<b>35,621</b>
Free cash flow	76,077	(129,462)	(57,350)	20,686	(77,353)	51,625	44,029	45,791

Source: Company, Daiwa forecasts

**Financial summary continued ...**
**■ Balance sheet (Rs m)**

As at 31 Mar	2007	2008	2009	2010	2011	2012E	2013E	2014E
Cash & short-term investment	137,201	117,431	109,671	48,585	53,189	26,072	61,699	97,320
Inventory	4,821	4,059	5,427	5,446	5,172	4,518	4,685	4,866
Accounts receivable	18,316	27,224	39,618	33,117	39,840	36,711	36,311	36,494
Other current assets	35,987	65,753	85,271	74,825	70,973	71,909	71,909	71,909
<b>Total current assets</b>	<b>196,325</b>	<b>214,466</b>	<b>239,987</b>	<b>161,972</b>	<b>169,173</b>	<b>139,210</b>	<b>174,604</b>	<b>210,589</b>
Fixed assets	330,422	523,126	727,053	712,539	729,321	697,701	676,020	653,655
Goodwill & intangibles	26,588	35,654	52,215	49,976	47,473	47,473	47,473	47,473
Other non-current assets	11,920	1,348	2,815	1,200	1,172	1,172	1,172	1,172
<b>Total assets</b>	<b>565,254</b>	<b>774,593</b>	<b>1,022,070</b>	<b>925,687</b>	<b>947,139</b>	<b>885,557</b>	<b>899,270</b>	<b>912,889</b>
Short-term debt	35,209	117,137	118,716	80,634	106,821	0	0	0
Accounts payable	44,423	86,948	46,471	40,899	46,172	45,182	46,853	48,659
Other current liabilities	117,059	113,828	154,343	146,453	93,436	93,574	95,594	97,779
<b>Total current liabilities</b>	<b>196,691</b>	<b>317,913</b>	<b>319,530</b>	<b>267,985</b>	<b>246,429</b>	<b>138,756</b>	<b>142,447</b>	<b>146,438</b>
Long-term debt	139,175	141,081	272,906	216,520	283,893	321,808	321,808	321,808
Other non-current liabilities	26	1,028	281	991	3,668	3,668	3,668	3,668
<b>Total liabilities</b>	<b>335,892</b>	<b>460,021</b>	<b>592,718</b>	<b>485,496</b>	<b>533,990</b>	<b>464,232</b>	<b>467,923</b>	<b>471,914</b>
Share capital	10,223	10,320	10,320	10,320	10,320	10,320	10,320	10,320
Reserves/R.E./others	219,083	279,943	412,483	423,286	394,672	401,641	410,426	418,690
<b>Shareholders' equity</b>	<b>229,306</b>	<b>290,263</b>	<b>422,803</b>	<b>433,607</b>	<b>404,992</b>	<b>411,962</b>	<b>420,746</b>	<b>429,010</b>
Minority interests	56	24,309	6,549	6,584	8,245	9,363	10,601	11,966
<b>Total equity &amp; liabilities</b>	<b>565,254</b>	<b>774,593</b>	<b>1,022,070</b>	<b>925,686</b>	<b>947,227</b>	<b>885,557</b>	<b>899,270</b>	<b>912,889</b>
EV	195,901	325,264	448,669	415,322	505,938	465,267	430,878	396,622
<b>Net debt/(cash)</b>	<b>37,183</b>	<b>140,786</b>	<b>281,951</b>	<b>248,569</b>	<b>337,525</b>	<b>295,736</b>	<b>260,109</b>	<b>224,488</b>
BVPS (Rs)	112	141	205	210	196	200	204	208

**■ Key ratios (%)**

Year to 31 Mar	2007	2008	2009	2010	2011	2012E	2013E	2014E
Sales (YoY)	n.a.	9.1	18.4	(2.7)	5.4	(10.8)	3.7	3.9
EBITDA (YoY)	n.a.	21.6	10.2	(15.6)	19.3	(28.2)	5.1	5.6
Operating profit (YoY)	n.a.	41.2	0.6	(28.5)	(33.3)	(25.6)	10.7	10.3
Net profit (YoY)	n.a.	3.4	15.4	(52.2)	(23.6)	(47.7)	22.2	(5.2)
EPS (YoY)	n.a.	2.9	14.9	(52.2)	(23.6)	(47.7)	22.2	(5.2)
Gross-profit margin	61.0	67.1	64.6	57.7	59.9	53.8	54.3	54.9
EBITDA margin	38.6	43.0	40.0	34.7	39.3	31.6	32.1	32.6
Operating-profit margin	21.8	28.2	24.0	17.6	11.2	9.3	9.9	10.5
ROAE	15.7	14.3	12.0	4.8	3.7	2.0	2.4	2.2
ROAA	6.4	5.5	4.8	2.1	1.7	0.9	1.1	1.0
ROCE	9.4	11.0	7.8	5.0	3.3	2.5	2.8	3.1
ROIC	14.0	14.3	9.3	5.0	3.6	2.3	2.4	2.6
Net debt to equity	16.2	48.5	66.7	57.3	83.3	71.8	61.8	52.3
Effective tax rate	2.0	4.0	n.a.	8.5	0.8	12.0	20.0	25.0
Accounts receivable (days)	38.3	43.7	54.1	60.5	57.6	67.8	62.3	59.8
Payables (days)	93.0	126.0	108.1	72.7	68.8	80.9	78.6	78.5
Net interest cover (x)	25.6	n.a.	5.6	3.1	3.1	2.2	3.0	2.6
Net dividend payout	2.9	2.9	2.7	3.8	7.7	12.6	10.3	10.9

Source: Company, Daiwa forecasts

**■ Company profile**

Reliance Communications (RCOM) is India's second-largest mobile-service provider in terms of subscriber numbers. The company offers wireless services using both CDMA and GSM technology. Its subsidiaries include Reliance Globalcom, which operates an undersea cable network, and Reliance Infratel, which operates a passive-infrastructure business (Towers and domestic optic fibre network).

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