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### Regulatory developments on an even keel

Interconnect Usage Charge (IUC) review and proposed changes in licence fee/spectrum charge structure are two key issues clouding the earnings visibility in the wireless space. In this note, we elaborate these issues and analyze their likely impact on earnings. Contrary to the popular perception, our calculations suggest minimal impact. Bharti stays our top pick in the sector.

### Potential termination charge cut: Long way to go, traffic patterns to catch up

TRAI is reviewing the interconnect usage charge (IUC) framework, which could lead to a cut in termination charges (currently at Rs0.3/min). We expect IUC review to be a long drawn process given enormous stakes involved. A recent TRAI note pointed out, "there is no shortcut to this exercise", drawing parallels from such a review undertaken in the past by the British regulator Ofcom, which had lasted for almost two years. A potential cut in termination charges post the review is unlikely to meaningfully impact GSM wireless earnings, in our view. Although lower termination charges would negatively impact operators that have higher proportion of the traffic as in-bound, substitution from fixed line to wireless continues to lift the outgoing traffic, thus narrowing down the incoming-outgoing deficit. The proportion of incoming to outgoing minutes for GSM, although currently >1x, should reach parity within a few quarters.

### Wireless spectrum charge hike: Partial licence fee waiver to the rescue

Wireless spectrum charges (levied as percentage of Adjusted Gross Revenue) have been hiked by 100bp for allocations up to 8MHz and 200bp thereafter. If not passed-through, this could hurt EBITDA margin by ~100bp for Bharti and Idea but only ~40bp for RCOM given lower spectrum allocation/requirement in CDMA. However, for the larger incumbents, this shortfall could be more than compensated in FY10 by the partial licence fee waiver - an incentive for deeper coverage. Assuming that full 2% waiver accrues, margin accretion would be 110bp for Bharti, 150bp for Idea, and 50bp for RCOM. Net impact would therefore be neutral to positive for the listed majors.

### Bharti remains our top pick

Regulatory developments are unlikely to meaningfully impact earnings. We maintain **Buy** on Bharti which remains our top pick on highest earnings visibility in the current challenging margin environment, low capex intensity, unlevered balance sheet, and relatively better-positioned tower portfolio for potential value accretion. Valuations at 7.3x EV/EBITDA and 13.2x P/E FY10E are well supported by 25-30% earnings and EBITDA CAGR over FY08-10E. We also find the valuations attractive for RCOM given a significant discount of 25-35% v/s Bharti on EV/EBITDA and ~50% on P/E. We maintain **Buy** on RCOM based on upside to KPIs and market share post GSM scale-up. We believe that RCOM should be beneficiary of easing liquidity while concerns on leverage and margins appear overdone.

#### COMPARATIVE VALUATIONS (FY10)

COMPANY	RECO	CMP (RS)	TARGET (RS)	UPSIDE (%)	MCAP (US\$B)	EV (US\$B)	EPS (RS)	P/E (X)	EV/EBITDA (X)	EV/ SALES (X)	ROE (%)	ROIC (%)
Bharti	Buy	724	1,020	40.9	29.2	30.1	55.0	13.2	7.3	3.1	28.7	26.2
Idea	Neutral	53	UR	-	3.5	4.7	4.7	11.4	5.7	1.7	11.7	10.3
RCOM	Buy	217	350	61.3	9.4	11.6	31.5	6.9	4.6	2.0	19.1	13.6

Source: MOSL

## Potential termination charge cut: Long way to go, traffic patterns to catch up

TRAI is reviewing the interconnect usage charge (IUC) framework, which could lead to a cut in termination charges (currently at Rs0.3/min). We expect IUC review to be a long drawn process given enormous stakes involved. A recent TRAI note pointed out, “there is no shortcut to this exercise”, drawing parallels from such a review undertaken in the past by the British regulator Ofcom, which had lasted for almost two years. A potential cut in termination charges post the review is unlikely to meaningfully impact GSM wireless earnings, in our view. Although lower termination charges should negatively impact operators that have higher proportion of the traffic as in-bound, substitution from fixed line to wireless continues to lift the outgoing traffic, thus narrowing down the incoming-outgoing deficit. The proportion of incoming to outgoing minutes for GSM, although currently >1x, should reach parity within few quarters.

### What is Interconnect Usage Charge?

Interconnect Usage Charge (IUC) refers to the charges paid by a telecom operator to other operators, mainly for use of their network. The IUC regime currently in effect was established in 2003. Key IUC components include 1) Carriage Charge, 2) Termination Charge, and 3) Access Deficit Charge. Carriage charges are levied by NLD operators for carrying access traffic and are currently under forbearance with a ceiling tariff of Rs0.65/min. Termination charges are levied by the recipient network operator to the operator who originates a call and are meant to compensate for the costs incurred by the recipient operator in a calling-party-pays (CPP) regime. Termination charges have not been revised since 2003 when they were fixed by the regulator at Rs0.3/min. The third component of IUC - Access Deficit Charge - was mainly levied to compensate PSU incumbent (BSNL) for the losses in its unviable rural operations. The regulator has been reducing the ADC charges in a phased manner, which stand reduced to nil from September 2008.

### IUC regime change likely to be a long drawn process

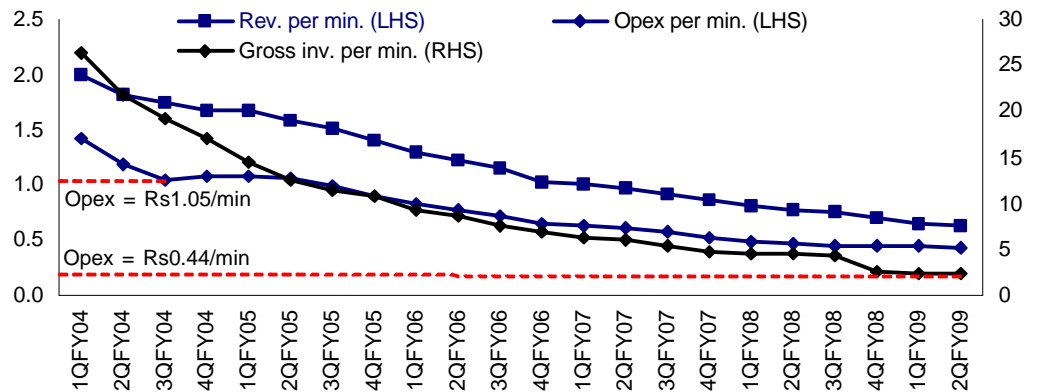
While carriage and ADC have been revised from time to time during the past five years of the current IUC regime, termination charges have remained unchanged at Rs0.3/min. TRAI is currently in the process of reviewing termination charges and is likely to issue a consultation paper shortly. However, we expect this process to be a prolonged one given the complexities involved in accessing the cost structure of incumbents and enormous stakes involved.

**Costs have declined substantially, yet below termination charges**

Given the multifold subscriber and traffic expansion over the past five years, there has been a demand for lowering the termination charges based on decline in costs coming from scale benefits. Since 3QFY04, Bharti's mobile traffic has grown by ~25x and the opex/min has declined by ~58% (even without adjusting for the rentals paid to tower segment). However, incumbents continue to believe that even the current termination charges are below cost, and therefore do not see the requirement of revising them downwards.

BHARTI AIRTEL: MOBILE OPEX PER MINUTE AT RS0.44

*Despite ~60% decline over the past four years, Bharti's current opex/min is ~50% higher than the termination charge*



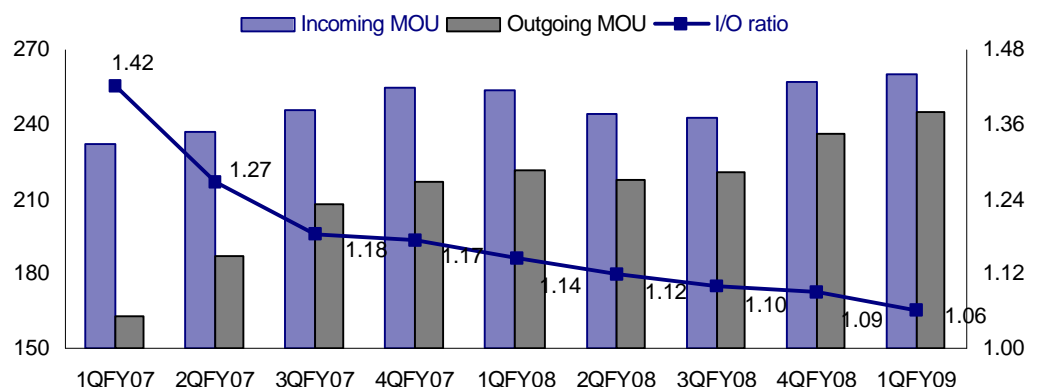
Source: Company/MOSL

**GSM Industry I/O ratio continues to decline**

TRAI data indicates that incoming to outgoing (I/O) ratio for the GSM industry has been consistently declining over the past several quarters. We believe this reflects continued substitution of originating traffic from fixed line to GSM wireless. Over the next few quarters, the I/O ratio is likely to reach 1.0x. We believe this would make the termination charge cut less relevant for the GSM industry as decline in revenue from incoming would be completely offset by an equivalent reduction in access costs paid for the outgoing calls.

GSM INCOMING/OUTGOING RATIO APPROACHING UNITY

*Incoming/Outgoing ratio of the GSM wireless industry continues to decline on fixed traffic substitution. At an I/O ratio of 1.0 (likely in few quarters), there will be no impact of the potential termination charge cut on wireless incumbents*



Source: TRAI/MOSL

## Wireless spectrum charge hike: Partial licence fee waiver to the rescue

Wireless spectrum charges (levied as percentage of Adjusted Gross Revenue) have been hiked by 100bp for allocations up to 8MHz and 200bp thereafter. If not passed-through, this could hurt EBITDA margin by ~100bp for Bharti and Idea but only ~40bp for RCOM given lower spectrum allocation/requirement in CDMA. However, for the larger incumbents, this shortfall could be more than compensated in FY10 by the partial licence fee waiver - an incentive for deeper coverage. Assuming that full 2% waiver accrues, margin accretion would be 110bp for Bharti, 150bp for Idea, and 50bp for RCOM. Net impact would therefore be neutral to positive for the listed majors.

### Higher spectrum charge from 4QFY09

Wireless operators would be required to pay higher spectrum charges as a percentage of their adjusted gross revenue (AGR) from 4QFY09. The current and revised spectrum charges are outlined in the table below:

SPECTRUM CHARGE (% OF AGR)		
	CURRENT	WEF 4QFY09
Up to 4.4/2.5* MHz	2	3
Up to 6.2/5* MHz	3	4
Up to 8MHz	4	5
Up to 10MHz	4	6
Up to 12.5MHz	5	7
Up to 15MHz	6	8
Beyond 15MHz	-	9

\* CDMA

Source: TRAI/DoT/MOSL

Based on 2QFY09 AGR data, spectrum charge hike would negatively impact EBITDA margin by 40-100bp. Estimated earnings impact is lowest for RCOM at 1.4%, followed by Bharti at 3.5%. Lower impact for RCOM is due to lower spectrum requirement and allocation in CDMA. Earnings impact on Idea is calculated at ~14%, much higher than Bharti and RCOM due to lower net margin and absence of non-wireless revenue. Idea's 2QFY09 net margin had been depressed and is likely to bounce back on lower interest costs post equity infusion at the parent level by Telekom Malaysia International (TMI) and at subsidiary level by Providence. Based on a normalized PBT margin of ~11% (v/s 6.7% in 2QFY09), we calculate earnings impact at ~11%.

## IMPACT OF SPECTRUM CHARGE HIKE (BASED ON 2QFY09, RS M)

	BHARTI	IDEA	RCOM
Adjusted Gross Revenue (AGR) - Access Business	60,252	18,448	22,902
Spectrum Charge (Current)	2,696	984	446
As % of AGR	4.5	5.3	1.9
Spectrum Charge (likely after increase)	3,587	1,203	675
As % of AGR	6.0	6.5	2.9
Increase in Spectrum Charge	891	219	229
Consolidated Revenue	90,203	22,993	56,449
Consolidated PBT	25,586	1,540	16,189
Increase as % of Consolidated Revenue	1.0	1.0	0.4
Increase as % of PBT	3.5	14.2	1.4

Source: TRAI/MOSL

*EBITDA margin impact of 100bp on Bharti and Idea, and 40bp on RCOM*

### Higher coverage to offset the impact for large incumbents on licence fee waiver

The government has announced an incentive in terms of 2% licence fee waiver to the wireless operators that cover more than 95% of developmental blocks in a non-metro service area. The reduced licence fee would be applicable from FY10. The definition of developmental blocks would be as per the Census of India, 2001. We expect the incumbents to be eligible for the waiver in most circles given their deep coverage.

## USOF LICENCE FEE: 2% WAIVER ELIGIBILITY

Percentage coverage of total number of development blocks in service area	Applicable USOF levy (% of AGR)	Applicable Annual Licence fee inclusive of USOF levy (% of AGR)		
		Category of service area (except metros)		
		"A"	"B"	"C"
Up to 95%	5% (no change)	10	8	6
More than 95%	3%	8	6	4

Source: DoT/MOSL

*We expect all wireless majors to be eligible for the 2% waiver in most circles*

Assuming that full 2% waiver accrues for wireless revenue in the non-metro service areas, we estimate earnings accretion of 3.9% for Bharti, 21.9% for Idea, and 1.6% for RCOM. The impact would be highest for Idea given lower net margin and lowest for RCOM led by higher net margin and lower ratio of wireless AGR/consolidated revenues.

## MARGIN UPSIDE FROM 2% LICENCE FEE WAIVER (BASED ON 2QFY09, RS M)

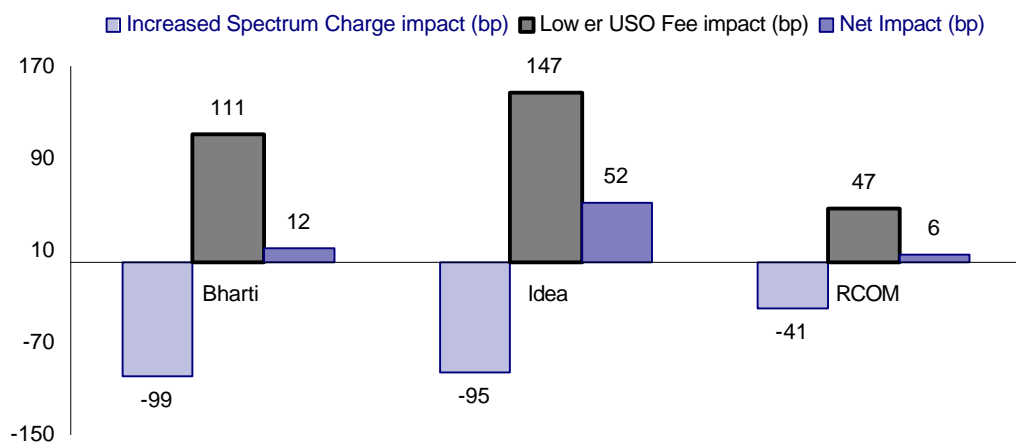
	BHARTI	IDEA	RCOM
Adjusted Gross Revenue (AGR) - Access Business	60,252	18,448	18,448
AGR from Metros (not eligible for the waiver)	10,376	1,547	5,293
AGR from Non-metro areas	49,877	16,901	13,155
Fee waiver assuming benefit in 100% of territory (2% of AGR)	998	338	263
Consolidated Revenue	90,203	22,993	56,449
Consolidated PBT	25,586	1,540	16,189
Increase as % of Consolidated Revenue	1.1	1.5	0.5
Increase as % of PBT	3.9	21.9	1.6

Source: TRAI/MOSL

*Likely margin accretion of 110bp for Bharti, 150bp for Idea and 50bp for RCOM*

CUMULATIVE IMPACT OF SPECTRUM CHARGE HIKE AND USO REDUCTION WILL BE NEUTRAL TO POSITIVE FOR LARGE INCUMBENTS

*Cumulative impact of change in licence fee/ spectrum charge structure will be neutral to positive for large incumbents*



Source: MOSL

COMPARATIVE VALUATIONS

	CMP (RS)	RATING	TARGET (RS)	UPSIDE (%)	MCAP (US\$B)	EV (US\$B)	P/E (X)			EV/EBITDA (X)			EV/SALES (X)		
							FY08	FY09E	FY10E	FY08	FY09E	FY10E	FY08	FY09E	FY10E
Bharti	724	Buy	1,020	40.9	29.2	30.1	20.5	15.8	13.2	12.4	9.2	7.3	5.2	3.8	3.1
Idea	53	Neutral	UR	-	3.5	4.7	13.5	17.0	11.4	9.8	7.7	5.7	3.3	2.2	1.7
RCOM	217	Buy	350	61.3	9.4	11.6	8.1	7.7	6.9	6.6	6.6	4.6	2.9	2.7	2.0
TTML	20	Not Rated	-	-	0.8	1.4	N.A.	N.A.	N.A.	16.0	12.3	9.4	3.8	3.3	2.8

	ROIC (%)			ROE (%)			EBITDA MARGIN (%)			NET DEBT/EBITDA (X)			NET DEBT/EQUITY (X)		
	FY08	FY09E	FY10E	FY08	FY09E	FY10E	FY08	FY09E	FY10E	FY08	FY09E	FY10E	FY08	FY09E	FY10E
Bharti	30.5	29.8	26.2	36.9	32.0	28.7	42.1	41.4	42.2	0.4	0.3	0.2	0.2	0.2	0.1
Idea	17.1	10.5	10.3	30.2	12.1	11.7	33.5	28.6	30.4	2.5	1.7	1.3	1.6	0.4	0.4
RCOM	17.4	12.8	13.6	22.7	19.6	19.1	43.0	40.9	43.6	1.2	2.1	1.3	0.4	0.6	0.5
TTML	-1.8	3.2	6.3	N.A.	N.A.	N.A.	23.6	27.1	29.4	6.4	4.7	3.7	N.A.	N.A.	N.A.

	CAPEX/SALES (%)			SALES GROWTH (%)			EBITDA GROWTH (%)			NET PROFIT GROWTH (%)			EPS GROWTH (%)		
	FY08	FY09E	FY10E	FY08	FY09E	FY10E	FY08	FY09E	FY10E	FY08	FY09E	FY10E	FY08	FY09E	FY10E
Bharti	51.2	29.5	24.4	45.9	38.0	23.1	52.6	35.6	25.6	57.4	29.5	20.4	57.4	29.3	20.4
Idea	69.8	62.0	33.5	53.9	42.7	29.4	53.8	21.8	37.8	110.2	-11.3	56.6	77.6	-20.8	48.9
RCOM	111.1	103.1	30.9	31.8	25.2	26.5	43.3	19.2	34.9	72.5	6.0	11.2	71.0	6.0	11.2
TTML	40.8	35.3	18.7	21.3	19.2	16.5	41.4	37.0	26.4	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.

Source: MOSL

**Appendix: Company wise calculations for spectrum charge hike**

BHARTI

	SPECTRUM	AGR (RS M)	SPECTRUM CHARGES	% OF AGR (PRESENT)	% OF AGR WEF 4QFY09	SPECTRUM CHARGES WEF 4QFY09
Delhi	10.0	6,111	255	4.2	6.2	377
Mumbai	9.2	2,725	166	6.1	8.1	221
Chennai	9.2	-	-	-	-	-
Kolkata	8.0	1,540	75	4.8	5.8	90
Maharashtra	6.2	2,948	127	4.3	5.3	157
Gujarat	6.2	1,999	82	4.1	5.1	101
A.P.	9.2	6,402	311	4.9	6.9	439
Karnataka	9.8	7,752	366	4.7	6.7	521
T.N.	9.2	5,823	297	5.1	7.1	414
Kerala	6.2	1,511	56	3.7	4.7	71
Punjab	7.8	2,943	140	4.8	5.8	169
Haryana	6.2	726	26	3.6	4.6	33
U.P.(W)	6.2	1,229	48	3.9	4.9	60
U.P.(E)	6.2	2,770	107	3.8	4.8	134
Rajasthan	6.2	3,558	138	3.9	4.9	174
M.P.	6.2	2,457	84	3.4	4.4	108
W.B. & A&N	6.2	1,374	54	3.9	4.9	67
H.P.	6.2	658	24	3.7	4.7	31
Bihar	8.0	3,704	182	4.9	5.9	219
Orissa	8.0	1,511	74	4.9	5.9	89
Assam	6.2	817	30	3.7	4.7	38
N.E.	4.4	575	14	2.5	3.5	20
Jammu & Kashmir	6.2	1,119	41	3.7	4.7	53
<b>Aggregate</b>		<b>60,252</b>	<b>2696</b>	<b>4.5</b>	<b>6.0</b>	<b>3,587</b>

IDEA

	SPECTRUM	AGR (RS M)	SPECTRUM CHARGES	% OF AGR (PRESENT)	% OF AGR WEF 4QFY09	SPECTRUM CHARGES WEF 4QFY09
Delhi	8.0	1,514	91	6.0	7.0	106
Mumbai	4.4	34	4	11.9	3.0	1
Chennai	4.4	-	-	-	-	-
Kolkata	-	-	-	-	-	-
Maharashtra	9.8	3,823	213	5.6	7.6	289
Gujarat	6.2	1,792	80	4.5	5.5	98
A.P.	8.0	2,865	160	5.6	6.6	188
Karnataka	4.4	-	-	-	-	-
T.N.	4.4	-	-	-	-	-
Kerala	8.0	2,252	128	5.7	6.7	151
Punjab	-	-	-	-	-	-
Haryana	6.2	712	26	3.7	4.7	33
U.P.(W)	8.0	1,993	104	5.2	6.2	124
U.P.(E)	6.2	658	28	4.2	5.2	34
Rajasthan	6.2	449	24	5.3	6.3	28
M.P.	8.0	2,300	126	5.5	6.5	149
W.B. & A&N	-	-	-	-	-	-
H.P.	4.4	57	2	2.8	3.8	2
Bihar	4.4	-	-	-	-	-
Orissa	4.4	-	-	-	-	-
Assam	-	-	-	-	-	-
N.E.	-	-	-	-	-	-
Jammu & Kashmir	-	-	-	-	-	-
<b>Aggregate</b>		<b>18,448</b>	<b>984</b>	<b>5.3</b>	<b>6.5</b>	<b>1,203</b>

## RCOM-CDMA

	SPECTRUM	AGR (RS M)	SPECTRUM CHARGES	% OF AGR (PRESENT)	% OF AGR WEF 4QFY09	SPECTRUM CHARGES WEF 4QFY09
Delhi	5.0	1,824	28	1.5	2.5	46
Mumbai	5.0	2,477	38	1.5	2.5	63
Chennai	5.0	-	-	-	-	-
Kolkata	5.0	893	10	1.1	2.1	19
Maharashtra	5.0	1,425	25	1.7	2.7	39
Gujarat	3.8	1,206	20	1.7	2.7	32
A.P.	5.0	1,763	33	1.9	2.9	51
Karnataka	5.0	1,362	22	1.6	2.6	36
T.N.	3.8	1,437	26	1.8	2.8	41
Kerala	3.8	382	6	1.6	2.6	10
Punjab	3.8	426	7	1.7	2.7	12
Haryana	3.8	256	5	2.1	3.1	8
U.P.(W)	3.8	967	19	2.0	3.0	29
U.P.(E)	5.0	1,572	30	1.9	2.9	46
Rajasthan	3.8	756	15	2.0	3.0	22
M.P.	5.0	1,111	20	1.8	2.8	31
W.B. & A&N	3.8	469	8	1.7	2.7	13
H.P.	2.5	88	2	1.8	2.8	2
Bihar	5.0	969	19	2.0	3.0	29
Orissa	3.8	246	5	1.9	2.9	7
Assam	2.5	-	-	-	-	-
N.E.	2.5	-	-	-	-	-
Jammu & Kashmir	2.5	1	0	-	-	-
<b>Aggregate</b>		<b>19,628</b>	<b>339</b>	<b>1.7</b>	<b>2.7</b>	<b>535</b>

## RCOM-GSM

	SPECTRUM	AGR (RS M)	SPECTRUM CHARGES	% OF AGR (PRESENT)	% OF AGR WEF 4QFY09	SPECTRUM CHARGES WEF 4QFY09
Delhi	4.4					
Mumbai	4.4					
Chennai	4.4					
Kolkata	6.2	100	3	3.0	4.0	4
Maharashtra	4.4					
Gujarat	4.4					
A.P.	4.4					
Karnataka	4.4					
T.N.	4.4					
Kerala	4.4					
Punjab	4.4					
Haryana	4.4					
U.P.(W)	4.4					
U.P.(E)	4.4					
Rajasthan	4.4					
M.P.	6.2	526	16	3.0	4.0	21
W.B. & A&N	6.2	284	9	3.0	4.0	11
H.P.	6.2	212	6	3.0	4.0	9
Bihar	8.0	916	37	4.0	5.0	46
Orissa	6.2	436	13	3.0	4.0	17
Assam	6.2	583	18	3.0	4.0	23
N.E.	6.2	217	7	3.0	4.0	9
Jammu & Kashmir	4.4					
<b>Aggregate</b>		<b>3,274</b>	<b>107</b>	<b>3.3</b>	<b>4.3</b>	<b>140</b>

Source: TRAI/MOSL



**N O T E S**



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