

# Strong 4Q, many moving parts


**Merrill Lynch**

Reena Verma Bhasin, CFA >> +91 22 6632 8667  
Research Analyst  
DSP Merrill Lynch (India)  
reena\_verma@ml.com

## Earnings & PO cut; Maintain Buy

We have cut our profit forecasts for Reliance Communication by 6% for FY08E & 10% for FY09E primarily factoring lower wireless market share in line with the company's 4Q FY07 performance. We have also cut our price target to Rs540/sh (versus Rs580 earlier), broadly in line with the earnings cut. We now expect RCom's share of wireless subscriber additions to range between 18-19% versus the Co's 4Q07 average share of ~18%, & our earlier expectation of 20-21% net adds share. However, we believe RCom will remain a dominant No.2 in terms of subscriber market share & earnings growth will stay strong; this drives our Buy.

## Capex guidance in line with Bharti; we prefer Bharti

Based on the Co's plans, we estimate RCom's consolidated FY08E capex at ~US\$3.7bn, broadly in line with Bharti's. RCom mgt said it will spend ~US\$2.5bn across various biz, excluding capex for planned rollout of ~20,000 shareable towers. Bharti is our preferred pick given similar spending plans of both majors.

## Points to note: GSM expansion; sub verification; dividends

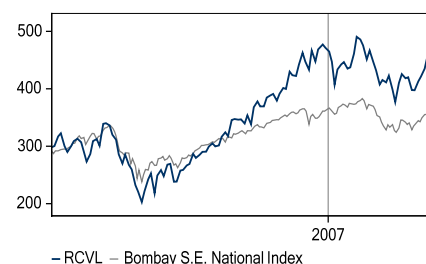
Key points to note: 1) Mgt said spectrum for its GSM expansion should become available in a few months. The Co expects to roll out its GSM expansion within 1 year of receiving spectrum; 2) The Co's recent deactivation of 5.6mn wireless subs included ~1mn GSM subs i.e. ~26% of its GSM sub base as of Dec '06. Prima facie, the clean-up appears large vs other GSM operators; 3) Along with results, RCom announced its first dividend; payout ratio is ~4% of FY07 profits.

## Strong 4Q07 as expected; broad trends in line with Bharti's

RCom's headline PAT for 4Q FY07 stood at Rs10.2bn, up 154% YoY & 11% QoQ. EBITDA was in line with our expectations, though headline profit was higher. Margin trends in key segments broadly mirrored Bharti's performance.

## Stock Data

Price	Rs477.10
Price Objective	Rs580.00 to Rs540.00
Date Established	1-May-2007
Investment Opinion	C-1-7
Volatility Risk	HIGH
52-Week Range	Rs186.40-Rs518.40
Mrkt Val / Shares Out (mn)	US\$23,682 / 2,044.6
Average Daily Volume	1,700,167
ML Symbol / Exchange	RLCMF / BSE
Bloomberg / Reuters	RCOM IN / RLCM.BO
ROE (2008E)	21.1%
Net Dbt to Eqty (Mar-2007A)	8.9%
Est. 5-Yr EPS / DPS Growth	30.0% / 20.0%
Free Float	33.3%



## Estimates (Mar)

(Rs)	2006A	2007A	2008E	2009E	2010E
Net Income (Adjusted - mn)	4,813	31,934	47,780	62,136	68,902
EPS	2.35	15.19	22.15	28.80	31.94
EPS Change (YoY)	NA	545.4%	45.8%	30.0%	10.9%
Dividend / Share	0	0.500	1.17	1.52	1.68
Free Cash Flow / Share	0.165	22.29	(31.60)	(27.01)	9.18

## Valuation (Mar)

	2006A	2007A	2008E	2009E	2010E
P/E	202.68x	31.40x	21.54x	16.57x	14.94x
Dividend Yield	0%	0.105%	0.245%	0.318%	0.353%
EV / EBITDA*	43.04x	18.55x	13.71x	10.51x	8.38x
Free Cash Flow Yield*	0.035%	4.67%	-6.62%	-5.66%	1.92%

\* For full definitions of *iQmethod*<sup>SM</sup> measures, see page 5.

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Refer to important disclosures on page 6 to 8. Analyst Certification on page 4. Price Objective Basis/Risk on page 4.

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# *iQprofile*<sup>SM</sup> Reliance Communication Ltd.

## Key Income Statement Data (Mar)

(Rs Millions)	2006A	2007A	2008E	2009E	2010E
Sales	110,314	144,683	183,548	235,961	302,252
Gross Profit	24,652	57,206	77,401	100,941	126,651
Sell General & Admin Expense	NA	NA	NA	NA	NA
Operating Profit	7,665	32,553	48,257	66,832	82,395
Net Interest & Other Income	(2,515)	(4)	443	(3,498)	(4,592)
Associates	NA	NA	NA	NA	NA
Pretax Income	5,150	32,550	48,701	63,333	77,803
Tax (expense) / Benefit	(337)	(616)	(921)	(1,198)	(8,901)
Net Income (Adjusted)	4,813	31,934	47,780	62,136	68,902
Average Fully Diluted Shares Outstanding	2,045	2,102	2,157	2,157	2,157

## Key Cash Flow Statement Data

Net Income (Reported)	4,813	31,934	47,780	62,136	68,902
Depreciation & Amortization	16,987	24,653	29,143	34,109	44,256
Change in Working Capital	17,304	56,192	21,877	27,984	43,675
Deferred Taxation Charge	NA	NA	NA	NA	NA
Other Adjustments, Net	0	(121)	0	0	0
Cash Flow from Operations	39,104	112,658	98,800	124,229	156,833
Capital Expenditure	(38,767)	(67,086)	(163,415)	(179,460)	(138,067)
(Acquisition) / Disposal of Investments	0	(11,925)	0	0	0
Other Cash Inflow / (Outflow)	0	(17,413)	0	0	0
Cash Flow from Investing	(38,767)	(96,424)	(163,415)	(179,460)	(138,067)
Shares Issue / (Repurchase)	0	0	0	0	0
Cost of Dividends Paid	0	(1,196)	(2,760)	(3,582)	(3,970)
Cash Flow from Financing	0	(1,075)	(2,760)	(3,582)	(3,970)
Free Cash Flow	337	45,572	(64,615)	(55,231)	18,766
Net Debt	32,938	18,238	85,614	144,427	129,630
Change in Net Debt	36	(14,736)	67,375	58,813	(14,796)

## Key Balance Sheet Data

Property, Plant & Equipment	214,263	330,423	464,695	610,046	703,857
Other Non-Current Assets	121	11,925	11,925	11,925	11,925
Trade Receivables	16,808	18,316	22,280	28,641	36,688
Cash & Equivalents	60,038	137,200	60,874	28,640	36,792
Other Current Assets	28,508	40,747	51,220	65,846	84,345
Total Assets	319,738	538,611	610,993	745,098	873,607
Long-Term Debt	92,976	155,438	146,488	173,067	166,422
Other Non-Current Liabilities	0	0	0	0	0
Short-Term Debt	0	0	0	0	0
Other Current Liabilities	109,247	179,186	215,500	264,471	334,693
Total Liabilities	202,223	334,624	361,987	437,538	501,115
Total Equity	117,515	203,987	249,006	307,560	372,492
Total Equity & Liabilities	319,738	538,611	610,994	745,098	873,607

## iQmethod<sup>SM</sup> - Bus Performance\*

Return On Capital Employed	NA	10.3%	11.5%	13.7%	14.3%
Return On Equity	8.2%	19.9%	21.1%	22.3%	20.3%
Operating Margin	6.9%	22.5%	26.3%	28.3%	27.3%
EBITDA Margin	22.3%	39.5%	42.2%	42.8%	41.9%

## iQmethod<sup>SM</sup> - Quality of Earnings\*

Cash Realization Ratio	8.1x	3.5x	2.1x	2.0x	2.3x
Asset Replacement Ratio	2.3x	2.7x	5.6x	5.3x	3.1x
Tax Rate (Reported)	6.5%	1.9%	1.9%	1.9%	11.4%
Net Debt-to-Equity Ratio	28.0%	8.9%	34.4%	47.0%	34.8%
Interest Cover	3.0x	NM	NM	19.1x	17.9x

## Key Metrics

\* For full definitions of iQmethod<sup>SM</sup> measures, see page 5.

## Company Description

Reliance Communication Ventures (RCVL) ranks among the largest private telecom operators in India. It has dominant wireless and long-distance businesses and is present in the fixed-line and broadband segments. RCVL also owns 100% of the global undersea cable FLAG. RCVL was listed in Mar '06 as a result of the de-merger of Reliance Industries. The Anil D. Ambani group is the promoter-shareholder of RCVL.

## Stock Data

Price to Book Value 3.9x

**Table 1: 4Q FY07 results summary**

(Rs mn)	Jan-Mar '06	Oct-Dec '06	Jan-Mar '07	YoY chng	QoQ chng
<b>Total Revenue</b>	<b>29704</b>	<b>37553</b>	<b>39369.1</b>	<b>33%</b>	<b>5%</b>
Access, interconnect charges and licence fee	10291	9491	9978	-3%	5%
% Of Revenue	34.6%	25.3%	25.3%		
<b>Net Revenue</b>	<b>19413</b>	<b>28062</b>	<b>29392</b>	<b>51%</b>	<b>5%</b>
Network operations cost	3349	4165	4423	32%	6%
% of net revenue	17.3%	14.8%	15.0%		
Selling and general costs	3817	6426	6166	62%	-4%
% of net revenue	19.7%	22.9%	21.0%		
Employee cost	1825	2200	2451	34%	11%
% of net revenue	9.4%	7.8%	8.3%		
Total Operating expenses	8991	12791	13040	45%	2%
<b>EBITDA</b>	<b>10422</b>	<b>15271</b>	<b>16352</b>	<b>57%</b>	<b>7%</b>
<b>EBITDA Margin</b>	<b>35.1%</b>	<b>40.7%</b>	<b>41.5%</b>		
Depreciation and amortisation	5457	6524	6378	17%	-2%
<b>EBIT</b>	<b>4965</b>	<b>8747</b>	<b>9975</b>	<b>101%</b>	<b>14%</b>
Net Interest	425	-657	-392	-192%	-40%
<b>PBT</b>	<b>4541</b>	<b>9404</b>	<b>10366</b>	<b>128%</b>	<b>10%</b>
Tax expense/(income)	138	130	149	8%	15%
<b>Recurring net profit</b>	<b>4403</b>	<b>9274</b>	<b>10217</b>	<b>132%</b>	<b>10%</b>
Extraordinary expense/(income)	374	30	-27.5	-107%	-192%
<b>Reported net profit</b>	<b>4029</b>	<b>9244</b>	<b>10244</b>	<b>154%</b>	<b>11%</b>
Tax rate(%)	3%	1%	1%		
Net profit margin	15%	25%	26%		

Source: ML research

**Table 2: Key divisional trends in 4Q FY07**

(Rs mn)	Jan-Mar '06	Oct-Dec '06	Jan-Mar '07	YoY chng	QoQ chng
<b>Consolidated Revenues</b>	<b>29704</b>	<b>37553</b>	<b>39369</b>	<b>33%</b>	<b>5%</b>
Consolidated EBITDA	10422	15271	16352	57%	7%
Consolidated EBITDA margin	35.1%	40.7%	41.5%		
<b>Wireless Revenues</b>	<b>21200</b>	<b>27520</b>	<b>29692</b>	<b>40%</b>	<b>8%</b>
Wireless EBITDA	7571	10293	11511	52%	12%
Wireless EBITDA margin	35.7%	37.4%	38.8%		
<b>Global Revenues</b>	<b>14158</b>	<b>13335</b>	<b>12938</b>	<b>-9%</b>	<b>-3%</b>
Global EBITDA	2632	3552	3121	19%	-12%
Global EBITDA margin	18.6%	26.6%	24.1%		
<b>Broadband Revenues</b>	<b>1948</b>	<b>3161</b>	<b>3299</b>	<b>69%</b>	<b>4%</b>
Broadband EBITDA	606	1486	1611	166%	8%
Broadband EBITDA margin	31.1%	47.0%	48.8%		

Source: ML research

## Price Objective Basis & Risk

### Reliance Communications

Our price target of Rs540/sh pegs RCom at a PE of ~19x FY09E & EV/EBITDA of ~12x FY09E. This represents ~15-20% discount to Bharti on a PE basis & ~5-10% discount on an EV/EBITDA basis. We think a discount versus Bharti is justified given RCom's relatively higher execution & technology risks. However, the discount is unlikely to be very deep in the current rapid growth environment.

Key risks stem from 1) unexpected slowdown of subscriber growth in the Indian telecom market, 2) higher-than-expected capex towards GSM expansion.

### Bharti (BHTIF; C-1-9; Rs812.05)

Our price target of Rs1000/sh places Bharti at the upper-end of its historical trading range. Our PO pegs Bharti at a PE of 24x Mar '09 and EV/EBITDA of 13x Mar '09 versus its historical trading range of 18-24x on PE basis and 10-13x on EV/EBITDA basis. We think the stock will continue to trade close to its upper range pending any major changes in competitive landscape.

Key risks stem from 1) unexpected growth slowdown in the Indian market, 2) unforeseen financial burden from likely 3G auctions, and 3) unexpected pressure on RoE due to overseas expansion plans.

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**iQmethod<sup>SM</sup> Measures Definitions**

<b>Business Performance</b>	<b>Numerator</b>	<b>Denominator</b>
Return On Capital Employed	$\text{NOPAT} = (\text{EBIT} + \text{Interest Income}) * (1 - \text{Tax Rate}) + \text{Goodwill Amortization}$	$\text{Total Assets} - \text{Current Liabilities} + \text{ST Debt} + \text{Accumulated Goodwill Amortization}$
Return On Equity	Net Income	Shareholders' Equity
Operating Margin	Operating Profit	Sales
Earnings Growth	Expected 5-Year CAGR From Latest Actual	N/A
Free Cash Flow	Cash Flow From Operations – Total Capex	N/A
<b>Quality of Earnings</b>		
Cash Realization Ratio	Cash Flow From Operations	Net Income
Asset Replacement Ratio	Capex	Depreciation
Tax Rate	Tax Charge	Pre-Tax Income
Net Debt-To-Equity Ratio	$\text{Net Debt} = \text{Total Debt, Less Cash \& Equivalents}$	Total Equity
Interest Cover	EBIT	Interest Expense
<b>Valuation Toolkit</b>		
Price / Earnings Ratio	Current Share Price	Diluted Earnings Per Share (Basis As Specified)
Price / Book Value	Current Share Price	Shareholders' Equity / Current Basic Shares
Dividend Yield	Annualised Declared Cash Dividend	Current Share Price
Free Cash Flow Yield	Cash Flow From Operations – Total Capex	Market Cap. = Current Share Price * Current Basic Shares
Enterprise Value / Sales	$\text{EV} = \text{Current Share Price} * \text{Current Shares} + \text{Minority Equity} + \text{Net Debt} + \text{Other LT Liabilities}$	Sales
EV / EBITDA	Enterprise Value	Basic EBIT + Depreciation + Amortization

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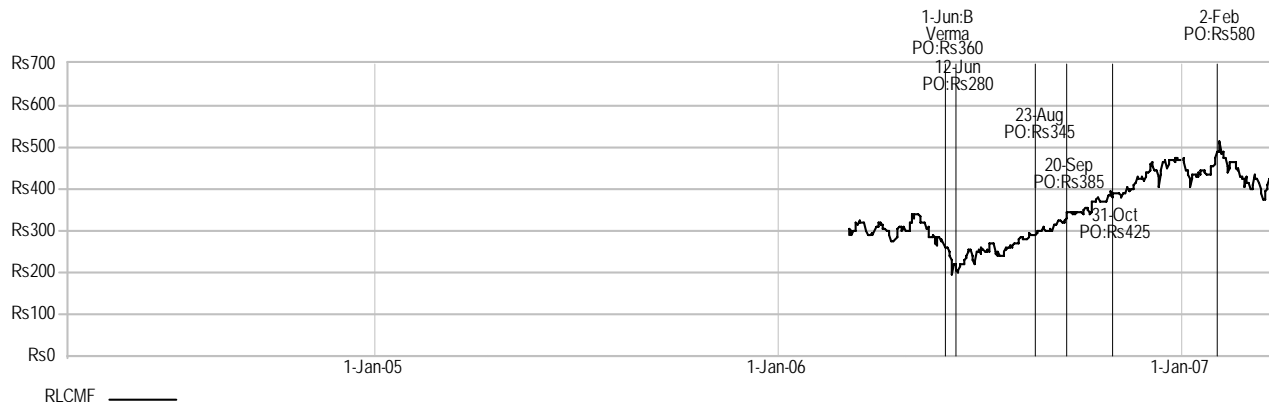
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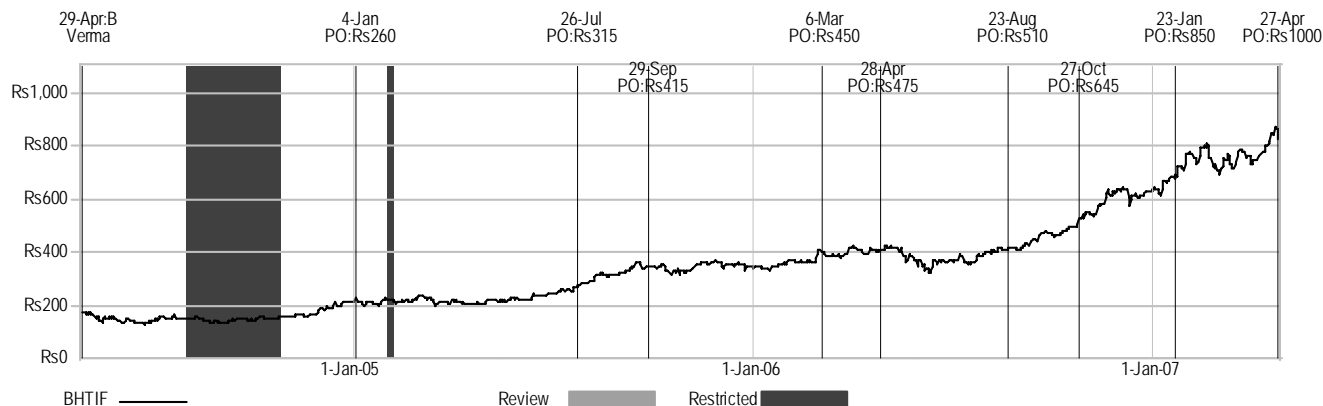
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B : Buy, N : Neutral, S : Sell, PO : Price objective, NA : No longer valid

The Investment Opinion System is contained at the end of the report under the heading "Fundamental Equity Opinion Key". Dark Grey shading indicates the security is restricted with the opinion suspended. Light Grey shading indicates the security is under review with the opinion withdrawn. Chart current as of March 31, 2007 or such later date as indicated.

### BHTIF Price Chart



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Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	89	44.50%	Buy	18	24.32%
Neutral	85	42.50%	Neutral	16	22.22%
Sell	26	13.00%	Sell	8	40.00%

### Investment Rating Distribution: Global Group (as of 31 Mar 2007)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	1562	45.16%	Buy	415	30.09%
Neutral	1615	46.69%	Neutral	446	30.65%
Sell	282	8.15%	Sell	49	19.76%

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