Tulip Telecom Update

11 March 2011

Jaypee Research Desk

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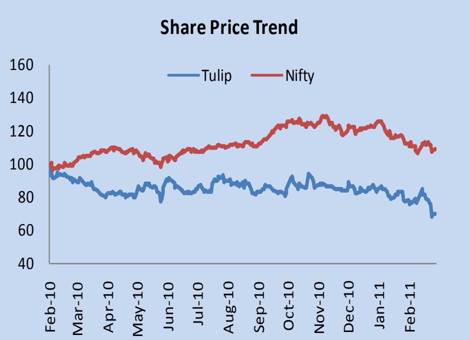
UPDATE NOTE | **CMP: ₹141.3** | **TARGET: ₹230** | **BUY**

As on Mar 10, 2011.	
Market Cap. (₹ Mn.)	20474
52 Week High/Low	₹201.4/135
Book Value	₹64
Face Value	₹2
Codes	
BSE Code	532691
NSE Symbol	TULIP
Bloomberg Code	TTSL IN
Reuters Code	TULP.BO

Shareholding Pattern

	Dec 2010	Sep 2010	Jun 2010
Promoters	68.96	68.96	68.96
FII	19.38	20.98	25.01
DII	1.87	2.01	1.34
Others	9.79	8.05	4.69



Share Price Returns (%)

	1M	6M	12M
Absolute	-10.5%	-15.8%	-22%
Relative	-7.4%	-14.5%	-28.3%

Archit Singhal
asinghal@jaypeeindia.com

Contact No:
+91 22 4354 2009

Jaypee Capital Services Ltd. organized a management conference call of the Senior Management of Tulip Telecom with a few investors on March 09, 2011.

Key take-away from the call:

A brief about Tulip Telecom and growth in the market:

The Enterprise data market in India is around $1.6 billion out of which around 43% comes from MPLS/VPN segment. The MPLS/VPN segment is expected to grow at a CAGR of 34% for FY09-14 and the Enterprise Data market is expected to grow at a CAGR of 22% for FY09-14.

Tulip is 5th largest player in the Enterprise data market with a share of 11% and is the leader in the MPLS/VPN segment with a market share of 30% as on FY10. The company provides last mile data connectivity to Enterprises and has a vast reach to over 2000 locations in India with a wireless/fiber network in various cities and it leases out the inter-city fiber from various telcos like Bharti, RCOM and government organizations like GAIL, RAILTEL. For the past 2 years, Tulip has been shifting its revenue mix and has been reducing the contribution from Network Integration business which is a low margin business for the company. The company has also been shifting its revenue mix to fiber which is also improving its margins.

How is Tulip different from the peers?

The largest USP of the company is the unique last mile network and a reach which is unmatched by any other last mile network player. The company has a significant edge over its peers in the tier-2 and tier-3 cities with a reach to over 2000 locations in India. Secondly a leadership in the fast growing MPLS/VPN segment gives the company an edge over the peers.

Investment into fiber in past 2 years:

The company was earlier catering to the MPLS/VPN segment and that too on wireless network. It has maintained its leadership in the MPLS segment for the past 3 years. Tulip which was earlier catering to less than 20% of the Enterprise Data Market increased its addressable market to over 90% of the Enterprise market in India by investing into fiber network. It can cater to the fiber segment of MPLS/VPN and to other segments of Enterprise Data Market like NDLS etc.

Improvement in EBITDA margins

The company has been observing a consistent improvement in EBITDA margins for the last 2 years. One of the reasons for the same is the diversification of business into the higher EBITDA margin business of fiber.

The current EBITDA margins of the company are in the range of 28%. The fiber business is a higher margin business and the company is observing a higher fiber order input where the fiber business accounts for more than 30% of total business. The company expects its margins to be 500bps above the current margins theoretically in 2-3 years when fiber contributes around 2/3rd of the total business. However, according to the management, a realistic margin expectation in 2 years would be 30-31% given that there would be an ARPU pressure going ahead as well.

Fiber has higher bandwidth connects and so high realization resulting in higher revenues whereas the costs for laying out the fiber network are sitting in the Balance sheet. Due to this the company has been observing better EBITDA margins as more revenues come from fiber. A large share of the buying of customers is for a fewer number of high bandwidth connects. Tulip has been able to get into these connects by having its fiber network and hence can get higher revenues.

Government projects:

Out of the 8 states which have recently finalized plans for improving transmission networks, Tulip has won projects in 5 of them. The costs and the service levels offered by Tulip are unmatched according to the management and the company is well placed to win a couple of more projects for providing bandwidth to the various states.

Regarding the capex:

Keeping the Bangalore data center out, the capex cycle has peaked out for the run-rate business on fiber and wireless with the company incurring around $100 million for these businesses an year. The capex intensity is heading downwards and the capex as a percentage of EBITDA will be lower going ahead.

Acquisition of Data center facility in Bangalore:

The company acquired a green field data center facility in Bangalore with 4 towers spread across an area of 9 lakh square feet. This data center facility is the largest in India and 3rd largest in Asia. *(For more details regarding the data center acquisition please refer to our reports – Tulip Telecom Event Update, Jan 18, 2011 and Tulip Q3FY11 Result Update, Feb 15, 2011).*

The data center facility is expected to be operational in the next 6 months and the company expects to achieve peak utilization in 3-4 years after which the data center could generate annual revenues of the order of ₹1000 crores with an EBITDA margin of around 50% as per management's expectation. The company already has 4 data centers before this acquisition, which contribute a very small proportion to the revenues and have EBITDA margins around 38%.

For the Bangalore data center, an investment of $ 200 million would be required over the next 3 years out of which the company has already paid around 1/3rd the amount for the acquisition. Tulip plans to get a PE investor for other 1/3rd portion and for the remaining 1/3rd portion, they plan to spend it over the next 3 years. Secondly the demand for data center is expected to outweigh the supply on a global basis and presence of the data center facility in Bangalore which is the IT hub is a key advantage for the company.

Deal with Hutchison:

The company signed a network to network integration agreement with Hutchison. Hutchison now has a footprint in India being among the fastest growing economies through Tulip and so is the case for Tulip which will have a presence overseas for its clients.

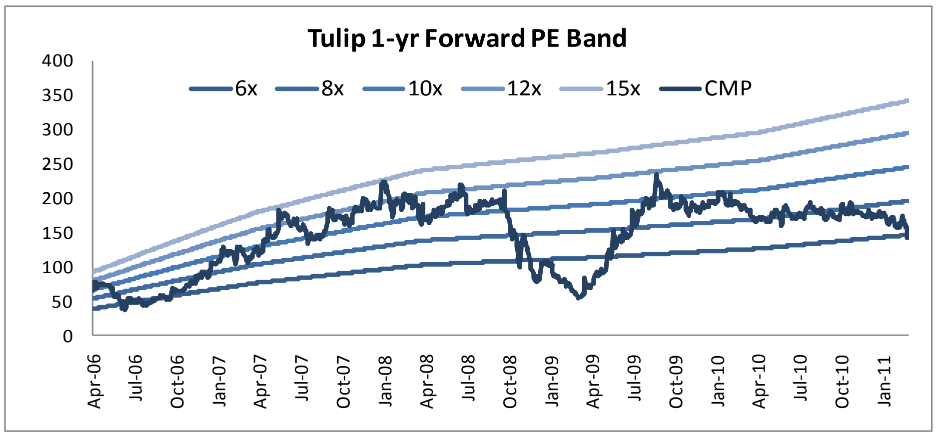
The Road ahead:

The company is observing 15% to 20% pressure in ARPU in recent times but there is a volume growth of around 40% so net-net the revenue is growing. Going ahead the company expects to see a strong revenue growth driven by its leadership position in the fast growing MPLS/VPN market and the increase in the size of its addressable market. The investment into fiber is expected to show an improvement in the EBITDA margins going ahead. The company has also diversified its business by acquiring the largest data center facility in India which is expected to be a big opportunity for the company on a longer term. Finally, the government projects and revenues from Hutchison can be additional revenues for the company going ahead.

Outlook and Valuation:

We maintain our positive outlook on the company. Improvement in the margins due to higher proportion of revenues coming from fiber, strong growth of the MPLS/VPN segment in EDM and revenues from government projects are opportunities for the company going ahead.

We have valued the company on the basis of DCF and Price-Earnings multiple giving a forward multiple of 9x to its FY12 EPS. We arrive at a core value of ₹221 using the weighted average of the price obtained from DCF and PE. We have valued the investment in Qualcomm at ₹9.2 per share by dividing the investment by the outstanding shares. **We maintain our Target Price of ₹230 for the stock.** Our Target Price provides a significant upside from the CMP of ₹141. We maintain our **Buy rating** on the stock.



Key Financials :

Income Statement Year ended 31 Mar (₹ m)	FY09	FY10	FY11E	FY12E
Net sales	**16,144**	**19,664**	**23,337**	**27,071**
growth (%)	*32.4%*	*21.8%*	*18.7%*	*16.0%*
Operating expenses	12,776	14,409	16,822	19,262
EBITDA	**3,368**	**5,255**	**6,515**	**7,809**
growth (%)	*37.1%*	*56.0%*	*24.0%*	*19.9%*
EBITDA Margin	*20.9%*	*26.7%*	*27.9%*	*28.8%*
Depreciation	414	1353	1670	2034
EBIT	**2,953**	**3,902**	**4,845**	**5,775**
Finance Charges	462	716	851	1295
Other Income	344	468	50	250
PBT	**2,836**	**3,654**	**4,044**	**4,729**
Tax (current + deferred)	330	899	971	1135
Tax as a %age of PBT	11.6%	24.6%	24.0%	24.0%
Net profit	**2,506**	**2,755**	**3,074**	**3,594**
Extra-ordinary items	0	0	0	0
Minority interests	0	0	0	0
Adjusted net profit	**2506**	**2755**	**3074**	**3594**
growth (%)	*13.3%*	*12.7%*	*18.9%*	*13.4%*
PAT Margin	*15.5%*	*14.0%*	*13.2%*	*13.3%*

Balance Sheet Year ended 31 Mar (₹ m)	FY09	FY10	FY11E	FY12E
Cash and Equivalents	3470	3470	3866	5906
Sundry Debtors	3242	5320	5754	6675
Inventories	916	688	688	688
Loans and Advances	1093	1559	1918	2225
Total Current assets	**8,722**	**11,037**	**12,226**	**15,494**
Investments	0	0	1,340	1,340
Net fixed assets	8,376	12,088	14,468	16,484
Other non-current assets/CWIP	3776	1212	1663	2113
Total assets	**20,874**	**24,337**	**29,697**	**35,431**
Current liabilities	2821	2838	3457	3958
Total Debt	11,234	12,220	14,226	16,224
Total liabilities	**14,055**	**15,059**	**17,683**	**20,182**
Share capital	290	290	290	290
Reserves & surplus	6,529	8,989	11,724	14,959
Shareholders' funds	**6,819**	**9,279**	**12,014**	**15,249**
Total equity & liabilities	**20,874**	**24,337**	**29,697**	**35,431**

Cash Flow Statement Year ended 31 Mar (₹ m)	FY09	FY10	FY11E	FY12E
Pre-tax profit	2,836	3,654	4,044	4,729
Depreciation	414	1353	1670	2034
Chg in working capital	-165	-2,297	-176	-726
Total tax paid	-330	-899	-971	-1135
Other operating activities	139	34	811	1255
Cash flow from operations (a)	**2,894**	**1,844**	**5,378**	**6,157**
Capital expenditure	-7,365	-2,501	-4,500	-4,500
Chg in investments/Other activities	4687	1160	-1311	29
Cash flow from investing (b)	**-2,678**	**-1,342**	**-5,811**	**-4,471**
Equity raised/(repaid) & Others	0	0	0	0
Debt raised/(repaid)	676	952	1,899	355
Cash flow from financing (c)	**676**	**952**	**1,899**	**355**
Net chg in cash (a+b+c)	**891**	**1,455**	**1,466**	**2,040**
Cash at the beginning of the year	54	945	2400	3866
Cash at the end of the year	945	2,400	3,866	5,906

Key ratios Year ended 31 Mar (₹ m)	FY09	FY10	FY11E	FY12E
EPS (₹)	17.3	19.0	21.2	24.8
EPS growth	34%	10%	12%	17%
EBITDA margin	20.9%	26.7%	27.9%	28.8%
EBIT margin	18.3%	19.8%	20.8%	21.3%
PAT Margin	15.5%	14.0%	13.2%	13.3%
ROCE	16.4%	18.2%	18.5%	18.3%
ROE	36.7%	29.7%	25.6%	23.6%
Debt/Equity	1.65	1.32	1.18	1.06

Valuations Year ended 31 Mar (₹ m)	FY09	FY10	FY11E	FY12E
PER (x)	9.8	8.9	8.0	6.9
Price/Book (x)	3.6	2.7	2.1	1.6
EV/Net sales (x)	2.07	1.70	1.43	1.23
EV/EBITDA (x)	9.9	6.4	5.1	4.3

Du Pont Analysis - ROE Year ended 31 Mar (₹ m)	FY09	FY10	FY11E	FY12E
Net margin (%)	15.5%	14.0%	13.2%	13.3%
Asset turnover (x)	0.8	0.8	0.8	0.8
Equity Multiplier (x)	3.06	2.62	2.47	2.32
Return on equity (%)	37%	30%	26%	24%

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Equity Research Products		
1.	Initiating Coverage	In depth analysis coupled with detailed explanation of investment rationale
2.	IPO Note	In depth analysis of an IPO with a recommendation for the same
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5.	Derivatives Daily	Daily update of the activities in the Derivatives segment
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RESEARCH

Head of Equity Research
Abbas Merchant +91 22 4354 2010

Information Technology
Vijay Gautam +91 22 4354 2019
Krupa Shah +91 22 4354 2019

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Economics
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Technical
Pranjal Shah +91 22 4062 1004

Quantitative
Raunak Chandra +91 22 4062 1016
Vinit Jain +91 22 4062 1016

SALES

Sales (Asia)
Vishad Turakhia +91 22 4062 1012
Hitash Dang +91 22 4354 1017
Rajat Vohra +91 22 4062 1011
Gautam Trehan +91 22 4354 2025

Sales (United States)
Amit Bansal +1 405 269 1322

Sales Trading (Equity)
Krishnakant Purohit +91 22 4062 1018
Jaiprakash Kataria +91 22 4062 1003
Gaurav Shah +91 22 4062 1007
Mahesh Bohra +91 22 4062 1005
Yogesh Dhumal +91 22 4062 1002
Sumeet Ramchandani +91 22 4062 1052
Jitendra Tolani +91 22 4062 1052

Sales Trading (Derivatives)
Premal Shah +91 22 4062 1004
Shirish Garodia +91 22 4062 1008
Ravi Agarwal +91 22 4062 1009
Rahul Sanghvi +91 22 4062 1009
Dhruval Gala +91 22 4062 1032
Deep Shroff +91 22 4062 1032
Deepak Purohit +91 22 4062 1099
Vishal Vadel +91 22 4062 1099

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*A **Buy** recommendation implies an upside of 10% or more from the current levels.*

*A **Sell** recommendation implies a downside of 10% or more from the current levels.*

*A **Neutral** recommendation implies an upside/downside of less than 10% from the current levels.*

Jaypee Offices Worldwide:

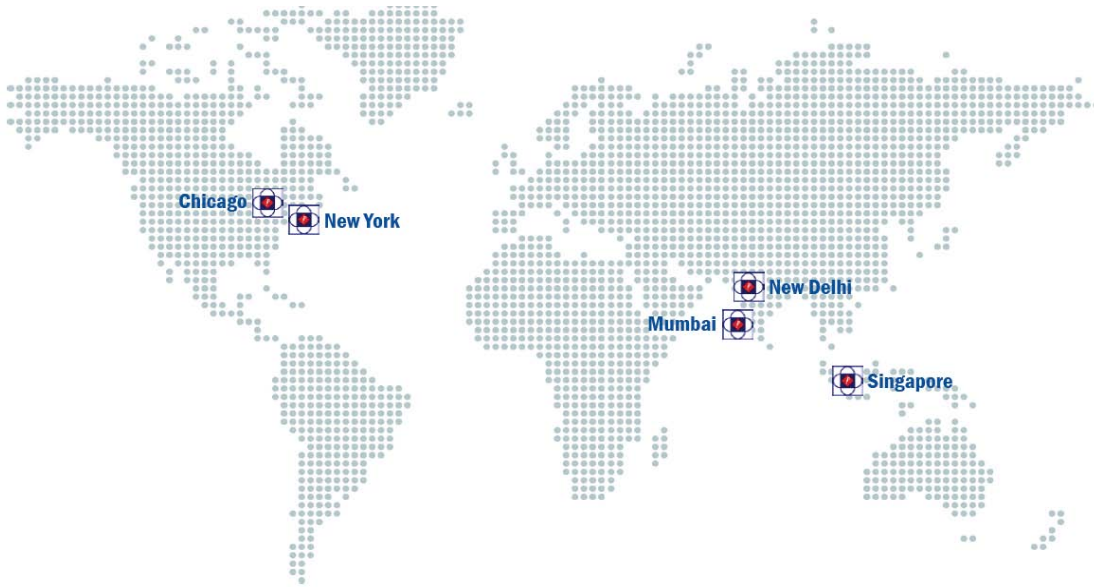
New York
150 Broadway
Suite 2200
New York, NY 10038
+1 212 537 6271
sales@jaypeeusa.com

Chicago
30 South Wacker Drive
Suite 1700
Chicago, IL 60606
+1 312 254 5044
sales@jaypeeusa.com

New Delhi
1114, Naurang House
21, K.G. Marg
New Delhi - 110 001, India
+91 11 6630 3030
sales@jaypeeindia.com

Mumbai
505, Arcadia
195, Nariman Point,
Mumbai - 400 021, India
+91 22 4062 1020
sales@jaypeeindia.com

Singapore
2 Shenton Way
#10-02 SGX Centre 1
Singapore 068804
+65 6438 0095
sales@jaypeesg.com



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