Flashnote

HSBC Global Research

Telecoms, Media & Technology
Diversified Telecoms
Equity – India

Reliance Communications

N(V): Unlocking not likely to be easy

- **Value unlocking in tower assets tough given lack of external tenancy and low network utilization of both GSM and CDMA**
- **Future of CDMA uncertain given progress on TD-LTE**
- **Cut target price to INR122 from INR152; rating Neutral (V)**

Neutral (V)

Target price (INR)	**122.00**
Share price (INR)	**102.90**
Potential return (%)	**18.6**

Performance	1M	3M	12M
Absolute (%)	9.9	-19.3	-38.7
Relative^ (%)	13.6	-9.2	-39.6

Index^	BOMBAY SE IDX
RIC	RLCM.NS
Bloomberg	RCOM IN
Market cap (USDm)	4,720
Market cap (INRm)	212,388
Enterprise value (INRm)	524239
Free float (%)	35

Note: (V) = volatile (please see disclosure appendix)

22 March 2011

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Unlocking tower assets- Though perceived as a catalyst by the market we believe unlocking tower assets will be tough, as the buyer will have to take a longer term bet on RCOM's GSM and CDMA businesses, both of which suffer from low network utilization. RCOM's longer term commitment to continue with CDMA is critical for tower valuations, as with rollout of 3G, progress on TD-LTE, prospects for CDMA will be reduced in our view and we expect CDMA tenancy to decline. We note that RCOM has pulled out from tower listing twice and post that the transaction with GTL also got called off. Our computation suggests a value of cUSD4bn for RCOM tower assets, factoring only anchor tenancy. However, the deal becomes value neutral for RCOM at c30% above our valuations per our analysis. Given unlocking initiatives markets tend to assume asset based valuations (refer to figure 5) will provide support, however failure to close deals/execution remains a concern.

RCOM has been among the worst performing Indian stocks in MSCI (down 44% in the last six months) with concerns about the balance sheet, 2G corruption probe and lacklustre operating performance. While we believe the recent debt refinancing of short term 3G debt with a loan facility from China Development Bank (CDB) is positive (this will prevent significant increase in interest cost but will not lower interest costs as 3G interest cost was being capitalised), leverage still remains high. As far as impact of the 2G corruption probe is concerned, we don't rule out the possibility of new entrants paying one time for start-up spectrum fee; we estimate impact for RCOM at USD335m. Separately business fundamentals remain weak, as despite investments in GSM, wireless revenues have been declining (refer figure 2). Initial porting data also suggests vulnerability of CDMA.

Cutting target price; rating is Neutral (V) – We are cutting our target price to INR122 from INR152 as we expect the operating parameters to deteriorate further due to poor quality of subscribers and limited ability to invest in 2G coverage. Further we expect pressure on CDMA to be aggravated by mobile number portability (MNP). As such we have cut our FY12e earnings by 17%. Our FY12 estimates are marginally (c3%) below consensus. That said, we believe the stock is trading cheaply (12% discount to six months average PE, down c30% YTD), and given the sell-off we see potential return of c18.6% from current levels. Due to recent volatility, we return the volatility indicator to our rating, and we rate the stock Neutral (V). The key upside risks will be the ability to monetize tower assets and sell 26% stake via induction of strategic partner over the next 6-9 months. The key downside risks are slower-than-estimated ramp-up in 3G and rapid subscriber churn in CDMA.

Financials & valuation

Financial statements

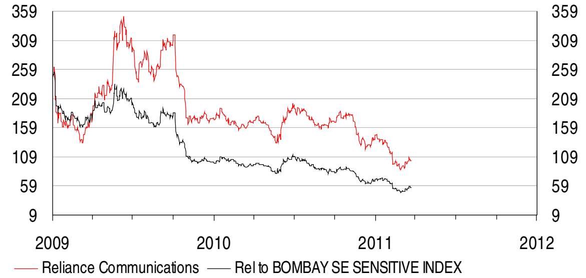
Year to	03/2010a	03/2011e	03/2012e	03/2013e
Profit & loss summary (INRm)				
Revenue	222,504	204,771	225,825	262,912
EBITDA	78,870	66,270	76,002	87,641
Depreciation & amortisation	-37,466	-39,829	-44,324	-46,719
Operating profit/EBIT	41,404	26,441	31,678	40,922
Net interest	11,863	-11,688	-11,320	-12,589
PBT	52,891	14,753	20,358	28,333
HSBC PBT	53,267	14,753	20,358	28,333
Taxation	-4,454	1,467	-3,054	-5,100
Net profit	47,041	14,430	15,505	21,415
HSBC net profit	47,344	14,430	15,505	21,415
Cash flow summary (INRm)				
Cash flow from operations	86,585	53,067	90,214	101,557
Capex	-58,080	-125,105	-32,990	-27,013
Cash flow from investment	-77,489	-135,987	-44,310	-39,601
Dividends	0	0	0	0
Change in net debt	-83,105	112,963	-45,903	-61,956
FCF equity	45,634	-81,852	45,903	61,956
Balance sheet summary (INRm)				
Intangible fixed assets	52,215	0	0	0
Tangible fixed assets	663,180	785,453	774,119	754,413
Current assets	164,152	175,797	181,775	185,198
Cash & others	48,585	48,000	48,000	48,000
Total assets	880,746	962,433	957,077	940,795
Operating liabilities	198,855	174,596	197,839	220,279
Gross debt	247,473	359,851	313,948	251,992
Net debt	198,888	311,851	265,948	203,992
Shareholders funds	387,825	381,392	396,896	418,312
Invested capital	632,107	738,654	710,055	671,332

Valuation data

Year to	03/2010a	03/2011e	03/2012e	03/2013e
EV/sales	1.8	2.6	2.1	1.6
EV/EBITDA	5.2	7.9	6.3	4.8
EV/IC	0.7	0.7	0.7	0.6
PE*	4.5	14.7	13.7	9.9
P/Book value	0.5	0.6	0.5	0.5
FCF yield (%)	21.5	-38.5	21.6	29.2
Dividend yield (%)	0.0	0.0	0.0	0.0

Note: * = Based on HSBC EPS (fully diluted)

Price relative



Source: HSBC

Note: price at close of 21 Mar 2011

Ratio, growth and per share analysis

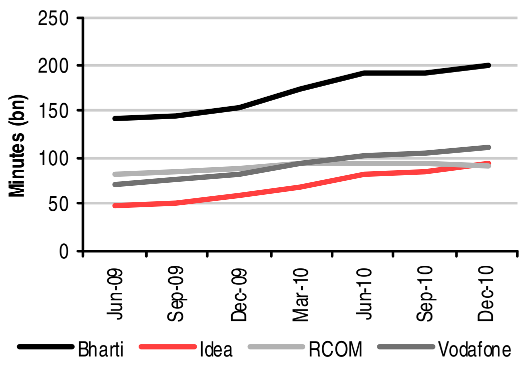
Year to	03/2010a	03/2011e	03/2012e	03/2013e
Y-o-y % change				
Revenue	-3.0	-8.0	10.3	16.4
EBITDA	-15.1	-16.0	14.7	15.3
Operating profit	-22.7	-36.1	19.8	29.2
PBT	-13.8	-72.1	38.0	39.2
HSBC EPS	-20.0	-69.7	7.4	38.1
Ratios (%)				
Revenue/IC (x)	0.3	0.3	0.3	0.4
ROIC	5.5	4.2	3.7	4.9
ROE	11.7	3.8	4.0	5.3
ROA	3.9	3.2	2.8	3.5
EBITDA margin	35.4	32.4	33.7	33.3
Operating profit margin	18.6	12.9	14.0	15.6
EBITDA/net interest (x)		5.7	6.7	7.0
Net debt/equity	50.3	79.6	65.0	47.2
Net debt/EBITDA (x)	2.5	4.7	3.5	2.3
CF from operations/net debt	43.5	17.0	33.9	49.8
Per share data (INR)				
EPS reported (fully diluted)	22.92	6.99	7.51	10.38
HSBC EPS (fully diluted)	23.07	6.99	7.51	10.38
DPS	0.00	0.00	0.00	0.00
Book value	188.98	184.78	192.29	202.67

Key issues with the stock

GSM investments have not helped, network quality remains a concern

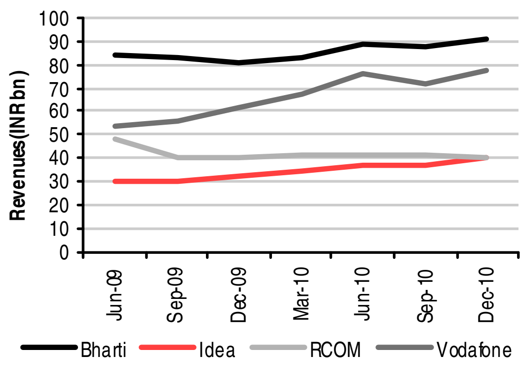
RCOM is the second largest wireless operator in terms of subscribers in India. While the company has been able to maintain this over the last two and a half years, it has seen a continuous fall in its revenue market share (RMS). In June 2007 it had the third highest RMS of 16.7% (c1.1% below second ranked Vodafone) which has fallen to 10.4% in Dec-10 (a fall of 6.3%) and its RMS rank fell to no 4. This is despite the launch of pan-India GSM services implying poor execution by the company. The latest active subscribers figures reported by the TRAI suggest that c34% of RCOM's subscribers are inactive reflecting poor quality subscribers.

Figure 1: RCOM minutes fall below Idea in Dec-10



Source: Company data, HSBC

Figure 2: RCOM's wireless revenues decline



Source: Company data, HSBC

CDMA outlook not robust

In our view, the CDMA business will remain under pressure in the near- to medium-term due to MNP implementation. However, given the company's focus on driving future growth through data, the CDMA could play an important role, in markets where RCOM has not bagged 3G spectrum. However with launch of 3G services and progress on TD-LTE, declining voice traffic, we expect prospects for CDMA to be reduced.

Sale of tower assets

RCOM has c50,000 towers with a tenancy of 1.76. Sale of tower assets should be positive for the company given the balance sheet concerns (net debt of cUSD7.2bn, net Debt/EBITDA of 3.5x), but we believe finding a buyer will be tough as both GSM and CDMA business of RCOM suffer from low network utilization. Our model suggests a fair value of cUSD4bn for RCOM's tower assets (implied EV/tower of INR3.6mn). However, we calculate that the deal would become value neutral for RCOM at c30% above our valuations (at an EV/tower of INR4.7mn). While RCOM's commitment to higher rentals can help the company fetch better valuations for its tower assets, this could hit its profitability in the long run in our view.

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Funding overview

We note that the company has two maturing FCCB's in the coming fiscal year FY12 amounting to cUSD1.5bn. The company has raised debt worth USD1.93bn from China Development Bank, however the proceeds will be used to refinance USD1.33bn of 3G loan and the remaining USD600mn will go towards purchase of 3G equipments from Chinese vendors. While this will prevent a significant increase in interest costs, interest costs will not fall as RCOM capitalized INR1.2bn of 3G interest cost in 3QFY11. Per our estimates, the company will generate free cash flows worth cUSD1bn in the next year suggesting a short fall of cUSD270mn to meet the FCCB's obligation. Monetization of tower assets may help reduce this burden, or alternatively the company may decide to restrict its capex in 3G or refinance with a short term loan, in our view.

Figure 3: RCOM net debt breakdown (December-10)

Particulars	Amount (INRmn)
Rupee loans	
Secured loans	30,000
Unsecured Loans	77,000
Total rupee loan	107,000
Foreign currency loans	232,348
Tranche #1 FCCB dated May 2011	16,804
Tranche #2 FCCB dated March 2012	51,621
Total FCCB	68,425
Foreign loan except FCCB	163,923
Less: Cash & Cash equivalents	-14,878
Net debt	**324,470**

Source: Company data, HSBC estimates

Figure 4: RCOM likely to face a deficit to meet its FCCB obligations

Particulars	FY12e
Tranche #1 FCCB dated May 2011	-297
Tranche #2 FCCB dated March 2012	-900
Interest payable on FCCB's	-322
Refinancing of domestic loan for 3G	-1,330
Other Foreign loans	
Receipts expected from CDB	1,930
Estimated capex in FY12	733
Capex refinanced through CDB loan	600
Free cash flow generated	1,245
Deficit estimated in FY12e to meet FCCB obligations	273

Source: HSBC estimates

Breakdown of value of assets, turning cautious on CDMA

Figure 5: RCOM asset valuation breakdown

RCOM Value	Amount (USD m)	Comments
2G Spectrum	4,000	Based on independent valuations of GSM business. Also supported by value of GSM spectrum and equipment.
3G Spectrum	1,908	Book value of 3G spectrum
CDMA	1,500	Assuming a data only case for CDMA business, we assume total device market at 22m byFY15e and RCOM share at 22%. Dongle ARPU estimated to decline from present INR800 to INR472 in the long-term.
Towers	4,000	Assuming reduced prospects for CDMA, we expect tower tenancy to go down from present 1.76x to 1.40x. Our assumptions don't factor any benefits from external tenancy.
Optic Fibre	1,800	We value 200,000kms of optical fibre at INR0.4m/km. Largely in line with when TCOM bought 15000kms of fibre from Bharti for INR500 crores. We are conservative have not factored anything for 65,000kms of submarine cable of which 22,000 is in US and the value per km is around 35,000USD and could mean an upside of USD1bn at least. Further company spent USD500m in buying Vanco, Flag and Yipes not considered
EV	13,208	
Net Debt	7,200	Debt adjusted as the per the latest results
Likely 2G spectrum payout	335	Assuming a payoff of USD9.9mn per MHz in 14 circles adjusting for the remaining life of spectrum for RCOM
Equity value	5,673	
Value per share	**124**	

Source: HSBC estimates

Valuation, Rating, and Risks

Given RCOM's deteriorating operating performance (ARPU's and MoU's falling by 26% and 24% y-o-y in December-10), we have cut our revenue estimates by 10% and 7% in FY12e and FY13e respectively and EBITDA estimates by 6% and 3% in FY12e and FY13e as we forecast further pressures going forward on account of MNP. We have also cut earnings estimates by 17% in FY12e and 1% in FY13e, respectively. Our revenues are 2% below and 3% above consensus estimates for FY12e and FY13e and earnings are 3% below and 6% above consensus estimates in FY12e and FY13e.

We value RCOM using a 12-month target price based on a blended approach of PE and DCF (equal weight). For our DCF valuation, we assume a cost of equity of 13% (HSBC's Strategy Team has computed a baseline cost of equity of 11% for India - risk free rate at 3.5% and equity risk premium of 7.5% and beta of 1, and we assume a rate 200bp above that to factor in risks associated with a stretched balance sheet), cost of debt of 10.5%, WACC of 13%. Given this we arrive at our DCF based value of INR161 per share. For the PE valuation, we have lowered our target multiple to 11x from 13x on poor earnings visibility and increased pressure on the CDMA business as a result of MNP. Our target multiple implies a c24% discount (on account to poor quality subscriber base) to Bharti's FY12e PE of 14.5x and 26% discount to Sensex FY12e multiple of c15x. The stock has traded at a 15% and 25% discount to Bharti and Sensex over the last 12 months respectively. Assigning equal weights to both DCF and PE we arrive at our target price of INR122 per share (down from INR152 previously). Under our research model, for Indian stocks with a volatility indicator, the Neutral band is 10 percentage points above and below our hurdle rate of 11.0%, or 1.0-21.0% potential return. Our target price of INR122 implies a potential return of 18.6%, thus, we maintain our Neutral rating, however we introduce the "V" flag due to recent volatility. The key downside risks are slower-than-estimated ramp-up in 3G and rapid subscriber churn in CDMA. Key upside risk would be ability to introduce a strategic investor through 26% stake sale in the company.

Figure 6: RCOM target price computation

Particulars	Remarks	Value (INR)
DCF	WACC of 13% (cost of equity 13%, cost of debt 10.5%) terminal growth rate 3.5%	161
PE	11x FY12e PE	83
Target price	**Assigning 50% weightage to DCF and PE**	**122**

Source: HSBC estimates

Figure 7: HSBC: Change in estimates for RCOM

Figs in INRmn unless specified	FY12e	FY13e
Sales		
New	225,825	262,912
Old	250,023	284,943
Change	-10%	-8%
EBITDA		
New	76,002	87,641
Old	80,665	94,388
Change	-6%	-7%
EPS		
New	7.51	10.38
Old	9.05	12.06
Change	-17%	-14%

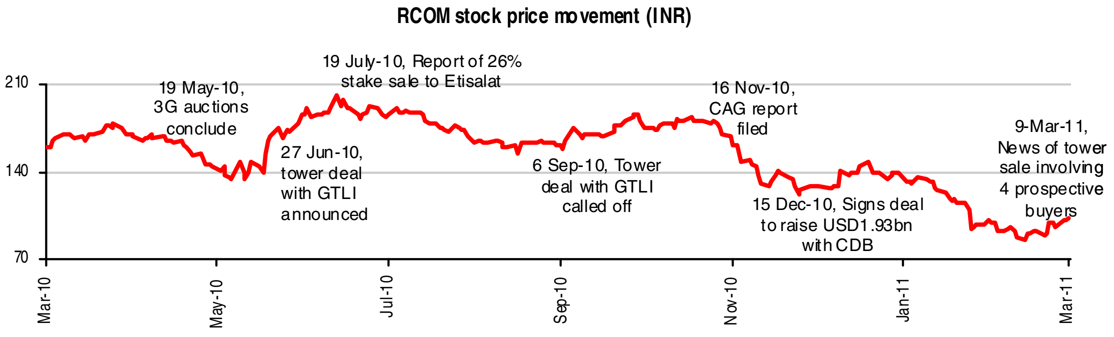
Source: HSBC estimates, Bloomberg

Figure 8: HSBC vs. Consensus

Particulars	Sales	EBITDA	EPS
FY12e	-2%	0%	-3%
FY13e	2%	0%	-8%

Source: HSBC estimates

Figure 9: RCOM key events and share price movements



Source: HSBC, DataStream for price data

Disclosure appendix

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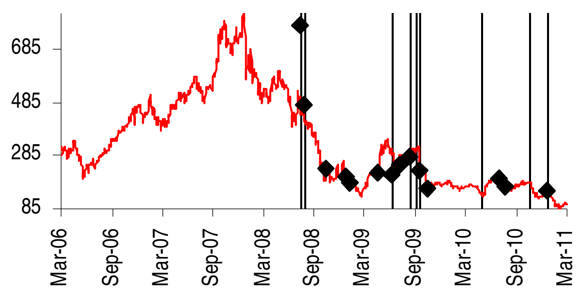
Overweight (Buy)	50%	(23% of these provided with Investment Banking Services)
Neutral (Hold)	36%	(21% of these provided with Investment Banking Services)
Underweight (Sell)	14%	(20% of these provided with Investment Banking Services)

Share price and rating changes for long-term investment opportunities

Reliance Communications (RLCM.NS) Share Price performance INR Vs HSBC rating history



Source: HSBC

Recommendation & price target history

From	To	Date
Restricted	Neutral	04 August 2008
Neutral	Neutral (V)	15 August 2008
Neutral (V)	Underweight (V)	29 June 2009
Underweight (V)	Neutral (V)	01 September 2009
Neutral (V)	Restricted	25 September 2009
Restricted	Underweight (V)	07 October 2009
Underweight (V)	Neutral (V)	20 May 2010
Neutral (V)	Underweight (V)	08 November 2010
Underweight (V)	Neutral	11 January 2011

Target Price	Value	Date
Price 1	775.00	04 August 2008
Price 2	475.00	15 August 2008
Price 3	235.00	05 November 2008
Price 4	202.00	13 January 2009
Price 5	180.00	27 January 2009
Price 6	218.00	05 May 2009
Price 7	214.00	29 June 2009
Price 8	250.00	23 July 2009
Price 9	280.00	01 September 2009
Price 10	Restricted	25 September 2009
Price 11	227.00	07 October 2009
Price 12	158.00	02 November 2009
Price 13	197.00	21 July 2010
Price 14	170.00	13 August 2010
Price 15	152.00	11 January 2011

Source: HSBC

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HSBC & Analyst disclosures

Disclosure checklist

Company	Ticker	Recent price	Price Date	Disclosure
RELIANCE COMMUNICATIONS	RLCM.NS	102.90	21-Mar-2011	2, 5, 7

Source: HSBC

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