Reliance Communications (RLCM.BO)

Equity

Sell: Audit Report – Revenue Reconciliation Needs Greater Clarity

- **Concerns shift to revenues from license fees** — As per press reports, the variation between FY08 wireless revenues reported by TRAI and the financial statements is due to certain additional items (sale of debtors, expired pre-paid cards and other one-off or non-wireless revenues). The variance seems over and above the Data/VAS/R-Del revenues, booked under the internet license, which hitherto was the key explanation. Though RCOM has countered the findings and the accounts have undergone various rounds of audits, we await greater clarity given (i) the material impact (if true) and (ii) further widening of the disparity in FY09 and 1QFY10.
- **Raises questions regarding "true" wireless profitability** — As per reports, RCOM booked certain revenue items totaling Rs26.5bn in FY08, which is key to the revenue reconciliation. It seems to comprise either (i) one-off items (sale of debtors, sale of expired pre-paid cards, refunds) or (ii) non-wireless items (handset sales/incentive, dealer network sharing and foreign sub income). If true, we estimate this may have resulted in "true" mobile ARPU and EBITDA being lower by c15% and c26% respectively in FY08.
- **Differential has widened significantly in FY09 & 1QFY10** — The difference between TRAI revenue data and financial statements increased from Rs25.7bn (17%) in FY08 to Rs43.6bn (25%) in FY09 and further to an alarming Rs17.4bn (36%) in 1QFY10. While Data/VAS revenues would have increased during this period, this alone seems inadequate to explain the widening difference, thus amplifying these concerns beyond FY08, with a potential impact on valuation.
- **Maintain Sell** — 1) High leverage (Net Debt at 3.2x FY10E EBITDA) makes RCOM more exposed to industry risks; 2) collateral damage from the ongoing tariff war on towerco tenancy and hence valuation and capital raising.

Sell/Medium Risk	3M
Price (26 Oct 09)	Rs226.15
Target price	Rs210.00
Expected share price return	-7.1%
Expected dividend yield	0.7%
Expected total return	**-6.5%**
Market Cap	Rs466,780M
	US$10,038M

Price Performance (RIC: RLCM.BO, BB: RCOM IN)

Statistical Abstract

Year to 31 Mar	Net Profit (RsM)	Diluted EPS (Rs)	EPS growth (%)	P/E (x)	P/B (x)	ROE (%)	Yield (%)
2008A	55,097	26.69	70.8	8.5	1.6	22.3	0.3
2009A	61,477	29.79	11.6	7.6	1.1	17.2	0.4
2010E	39,134	18.96	-36.3	11.9	1.0	8.9	0.7
2011E	36,951	17.90	-5.6	12.6	1.0	7.8	0.9
2012E	42,979	20.82	16.3	10.9	0.9	8.4	0.9

Source: Powered by dataCentral

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See Appendix A-1 for Analyst Certification and important disclosures.

Fiscal year end 31-Mar	2008	2009	2010E	2011E	2012E
Valuation Ratios					
P/E adjusted (x)	8.5	7.6	11.9	12.6	10.9
EV/EBITDA adjusted (x)	7.4	7.9	8.3	7.7	6.8
P/BV (x)	1.6	1.1	1.0	1.0	0.9
Dividend yield (%)	0.3	0.4	0.7	0.9	0.9
Per Share Data (Rs)					
EPS adjusted	26.69	29.79	18.96	17.90	20.82
EPS reported	26.69	29.79	18.96	17.90	20.82
BVPS	140.63	204.85	222.12	237.77	256.35
DPS	0.75	1.00	1.50	2.00	2.00
Profit & Loss (RsM)					
Net sales	190,678	229,411	250,510	289,679	321,283
Operating expenses	-136,743	-175,924	-203,190	-240,096	-264,772
EBIT	**53,935**	**53,487**	**47,320**	**49,583**	**56,510**
Net interest expense	3,998	7,867	-5,688	-8,977	-8,219
Non-operating/exceptionals	0	0	0	0	0
Pre-tax profit	**57,933**	**61,354**	**41,632**	**40,606**	**48,291**
Tax	-2,836	123	-2,498	-3,655	-5,312
Extraord./Min.Int./Pref.div.	0	0	0	0	0
Reported net income	**55,097**	**61,477**	**39,134**	**36,951**	**42,979**
Adjusted earnings	55,097	61,477	39,134	36,951	42,979
Adjusted EBITDA	81,989	92,875	97,645	105,042	115,590
Growth Rates (%)					
Sales	31.8	20.3	9.2	15.6	10.9
EBIT adjusted	65.7	-0.8	-11.5	4.8	14.0
EBITDA adjusted	43.3	13.3	5.1	7.6	10.0
EPS adjusted	70.8	11.6	-36.3	-5.6	16.3
Cash Flow (RsM)					
Operating cash flow	**106,390**	**59,756**	**68,701**	**108,270**	**93,604**
Depreciation/amortization	28,054	39,388	50,325	55,459	59,080
Net working capital	2,563	-33,243	-32,651	6,883	-16,674
Investing cash flow	**-212,034**	**-255,510**	**-84,201**	**-67,570**	**-57,289**
Capital expenditure	-212,034	-255,510	-84,201	-67,570	-57,289
Acquisitions/disposals	0	0	0	0	0
Financing cash flow	**86,190**	**138,951**	**-6,999**	**-13,621**	**-12,863**
Borrowings	83,834	133,406	8,378	0	0
Dividends paid	-1,742	-2,322	-3,483	-4,644	-4,644
Change in cash	**-19,454**	**-56,804**	**-22,499**	**27,079**	**23,451**
Balance Sheet (RsM)					
Total assets	**774,593**	**1,022,070**	**1,033,768**	**1,082,295**	**1,108,438**
Cash & cash equivalent	117,431	109,724	87,225	114,304	137,755
Accounts receivable	27,224	39,618	41,752	48,280	53,547
Net fixed assets	523,126	727,053	760,929	773,041	771,251
Total liabilities	**460,021**	**592,718**	**568,764**	**584,984**	**572,791**
Accounts payable	156,213	159,718	127,387	143,607	131,415
Total Debt	258,217	391,623	400,000	400,000	400,000
Shareholders' funds	**314,573**	**429,352**	**465,003**	**497,311**	**535,646**
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	43.0	40.5	39.0	36.3	36.0
ROE adjusted	22.3	17.2	8.9	7.8	8.4
ROIC adjusted	13.2	8.6	5.7	5.6	6.2
Net debt to equity	44.8	65.7	67.3	57.4	49.0
Total debt to capital	45.1	47.7	46.2	44.6	42.8

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Revenue items need more clarity

We have attempted to reconstruct the reconciliation between TRAI's reported wireless revenue (Rs126.5bn) and the revenue reported in quarterly disclosures (Rs152.1bn) based on press reports (*Financial Express* dated Oct 14) and other media reports.

In addition to the revenues booked under the Internet license (under the subsidiary RCIL), which relate to the issue of license fee liability, the other items in the reconciliation raise issues of revenue classification and "true" wireless profitability. If true, some of these items either appear to be one-off in nature or not related to the wireless business, totaling up to Rs26.5bn in FY08. It is therefore over and above management's earlier explanation of the revenue difference being mainly on account of the Data/VAS/R-del revenues, which are booked under the internet (non-UASL) license.

Management has denied these differences and maintained that the accounts have been audited by the statutory auditors as well as undergoing a peer group review appointed by SEBI as recently as May 2009. However, given (i) the material impact on wireless profitability (if true) and (ii) significant widening of the revenue disparity in FY09 and 1QFY10, we await further clarity on these issues/items from the company.

Figure 1. Reconciliation between revenues reported to TRAI and quarterly statement

All figs in Rs m	FY08	Comments
TRAI reported revenue	**126,473**	As disclosed by TRAI (incl. wireline as well)
One-off items		
Sale of debtors (earlier written off in the books)	6,170	Sale of debtors to 4 entities, income pertaining to previous years booked again?
License fee refund and reversal of interconnect	2,260	Possibly one-off in nature
Expired prepaid cards sold	3,790	
Sub-total (a)	**12,220**	
Revenues not related to wireless services		
Retail income from foreign subsidiaries	2,290	
Income of Reliance webstore	1,630	
Income from sale of handsets	5,090	Probably arising out of handset bundling
Handset incentives	670	
USO subsidy on Rural DELs	1,580	
Sharing of dealer network	3,000	Income booked for sharing of dealer network with Macronet (P) - 21% held by RCOM
Sub-Total (b)	**14,260**	
Others (c) – Balancing figure estimated by us	**(818)**	Doesn't reconcile fully as TRAI revenues include wireline revenues also but does not include revenues booked under ISP license
Reported revenues (TRAI rev + a + b+ c)	**152,135**	**As reported in the Financial Statements**

Source: Citi Investment Research and Analysis, TRAI, Press reports (Financial Express)

Restated profitability may have been materially lower

If the above items are correct, we believe that the "true" ARPU and wireless EBITDA in FY08 may have been lower by 15% and 26% respectively.

Figure 2. Restated ARPU and EBITDA margins

FY08	Rs m	Comments
Reported Revenue	**152,135**	As per Financial Statements
EBITDA	60,847	As per Financial Statements
EBITDA margin	40.0%	
Average Subs (m)	37.4	
Reported ARPU (Rs)	339	
As per Audit report findings		
Revenue	129,445	Deducting Rs26.5bn excl. the sale of pre-paid cards of Rs3.8bn
ARPU	288	
% impact	**-15%**	
Non-EBITDA generating rev.	6,720	Includes sale of handsets + Reliance Webstore sales
Sale of expired pre-paid card	3,790	Assuming it to be genuine income
EBITDA	44,877	Deducting (Rs26.5bn – Rs6.7bn – Rs 3.8bn) from reported EBITDA
% impact	**-26%**	

Source: Company reports, Citi Investment Research and Analysis

The revenue discrepancy has widened further

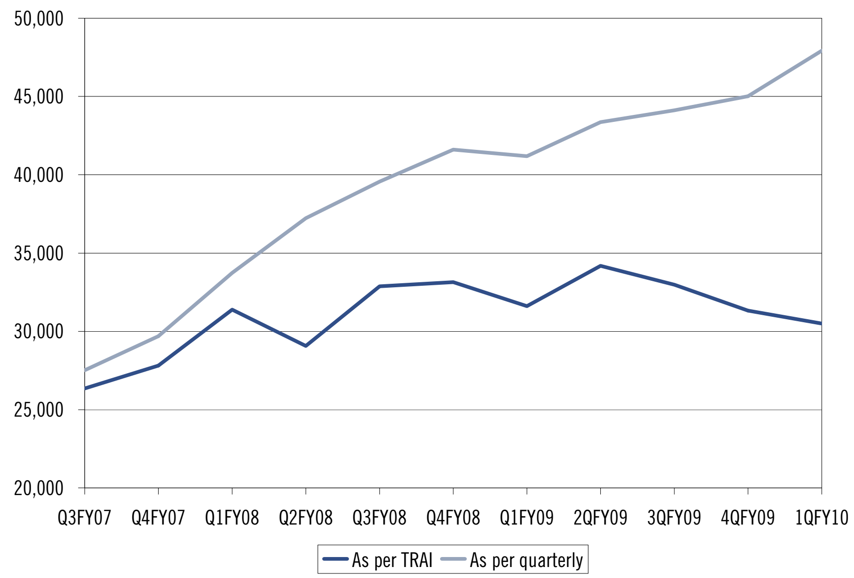
The difference between TRAI revenue data and financial statements increased from Rs25.7bn (17%) in FY08 to Rs43.6bn (25%) in FY09 and further to an alarming Rs17.4bn (36%) in 1QFY10. Increase in Data/VAS revenues alone cannot in out view explain this significant increase, thus raising and potentially amplifying these concerns beyond FY08.

Figure 3. RCOM's revenue difference as per reported to TRAI and quarterly has continued to widen

Rs m	Gross Revenues as per TRAI	Gross revenue as per Quarterly	Diff between gross revenues	% difference
1QFY10	30,491	47,931	(17,440)	-36%
FY2009	**130,097**	**173,677**	**(43,580)**	**-25%**
4QFY09	31,323	45,015	(13,692)	-30%
3QFY09	32,984	44,119	(11,135)	-25%
2QFY09	34,182	43,356	(9,175)	-21%
Q1FY09	31,608	41,187	(9,579)	-23%
FY2008	**126,473**	**152,135**	**(25,662)**	**-17%**
Q4FY08	33,146	41,608	(8,462)	-20%
Q3FY08	32,883	39,567	(6,685)	-17%
Q2FY08	29,063	37,230	(8,167)	-22%
Q1FY08	31,382	33,730	(2,348)	-7%
Q4FY07	27,812	29,692	(1,880)	-6%
Q3FY07	26,356	27,520	(1,164)	-4%

Source: Citi Investment Research and Analysis, TRAI, Company Reports

Figure 4. Gap between TRAI data and quarterly statement has continued to widen (Rs m)



Source: Citi Investment Research and Analysis

It is also important to note that a similar comparison for Bharti yields a different result, with the wireless revenue reported to TRAI being higher than the revenue booked in the audited accounts. This is because the revenue reported to TRAI, under-UASL, also includes fixed line revenues for integrated telcos like Bharti, as well as RCOM.

Figure 5. Bharti's rev difference between TRAI and quarterly has remained broadly unchanged

Rs m	Gross Revenues as per TRAI	Gross revenue as per Quarterly	Diff between gross revenues	% Difference
1QFY10	89,128	82,285	6,843	8%
4QFY09	88,960	82,216	6,744	8%
3QFY09	86,871	79,392	7,479	9%
2QFY09	80,093	72,843	7,250	10%
Q1FY09	76,493	69,150	7,342	11%
Q4FY08	69,240	64,201	5,039	8%
Q3FY08	63,282	56,105	7,177	13%

Source: Citi Investment Research and Analysis, TRAI, Company Reports

Other issues

1. As per the reports, the sale of debtors of Rs6.17bn is to four entities, namely Neptune Steel Strips Ltd., Shriyam Autofin Ltd., Mahima Mercantile Credit Ltd. and Traitrya Construction Fin Ltd. Though the sale may have happened at a big discount to the bill value, the ability of these companies to take on (from a funding perspective) and recover the debtors which were earlier written off, is questionable to us, especially if they pertained to the handset bundled schemes launched 4-5 years back (Monsoon Hungama). Since this is based on our interpretation of this reconciliation item, we await further clarity from the company on this and the other issues.

2. Though we have included sale of expired pre-paid cards (Rs3.8bn) in our restated ARPU and EBITDA calculations, it appears akin to pushing SIMs/recharge vouchers through, without it getting translated into actual usage by the consumers. This includes Rs1.5bn of pre-paid cards sold to Macronet (P) Ltd., which is 21% owned by RCOM as per 2008-09 Annual Report.

3. Company also had significant Capital work-in-progress (~Rs100bn) as on Jun'09 despite the full launch of its GSM network, the main reason for the increase in CWIP during FY08-09. RCOM's loans and advances also appear to be on the higher side relative to its size.

Figure 6. RCOM's capital WIP remains high despite full GSM launch

Rs bn	Sep-07	Dec-07	Mar-08	Jun-08	Sep-08	Dec-08	Mar-09	Jun-09
Capital WIP	79.5	139.2	148.3	178.4	189.3	191.6	114.1	103.5

Source: Citi Investment Research and Analysis

Figure 7. Loans and advances as % of total revenues

	FY08	FY09
Bharti	10.2%	16.2%
RCOM	22.7%	30.4%

Source: Citi Investment Research and Analysis

Reliance Communications

(RLCM.BO; Rs208.25; 3M)

Company description

RCOM is an integrated player in the Indian telecoms sector. It was listed on the Indian stock exchanges following the de-merger of Reliance Industries. RCOM is the second-largest player in the mobile segment, has an 80,000km-long India-wide optic-fiber network and owns the FLAG submarine cable network. RCOM has three business units: 1) Wireless, which includes a nationwide wireless network on CDMA and GSM; 2) Global Business comprising wholesale voice and data; and 3) Broadband for both retail and enterprise.

Investment strategy

We rate RCOM Sell/Medium Risk. There have been early signs of success of RCOM's GSM foray as traffic growth has picked up and tariffs are stable. However, recent tariff cuts make it susceptible to EBITDA and earnings decline especially given the high leverage (Net Debt/EBITDA of 3.2x FY10E). Sustainability of the performance in the remainder of FY10 will be key especially as RCOM comes up against launches by some of the other new GSM entrants, who will be pursuing the same traffic initially. GSM should help RCOM gain revenue market share, but gains at the operating level will likely be offset by interest and depreciation arising from significant capex. Reliance Infratel has also been signing new tenants, although its dependence on upstarts for tenancy raises question marks on their viability given the worsening competitive scenario.

Valuation

Our target price of Rs210 comprises (i) core business value of Rs170 based on 6.1x FY11E EV/EBITDA, at 10% discount to Bharti's implied target multiple (ex- towerco) plus (ii) Infratel value accretion of Rs40 based on long-term tenancy of 2.3. We believe some discount to Bharti is justified on account of the inherent risks of dual network, higher leverage, stretched FCF breakeven, and lack of clarity and consistency on accounting policies (especially related to finance income). Our towerco net value accretion of Rs40 is based on the following assumptions: 1) Long-term tenancy of 2.3 with captive tenancy of 1.6; 2) Capex recovery of 13%, 3) WACC of 11.3% and terminal growth rate of 3%; 4) Please note that the incremental value accretion to RCOM is calculated after netting off the contribution from the captive tenancy. Thus, it only reflects the value of the external revenues.

Risks

Our risk-rating system, which tracks 260-day share price volatility, assigns a High Risk rating to RCOM. We however assign Medium Risk rating given the improvement in the B/S and the credit markets. Upside risks to our target price include higher-than-expected market share gains in GSM and visibility on tenancy of RTIL with possible move towards value monetization. Easing of the macro credit environment and slower conversion of current liabilities to real debt would positively impact the earnings and sentiment on the stock.

Bharti Airtel

(BRTI.BO; Rs306.60; 2L)

Valuation

Our target price of Rs370 comprises (i) core business value of Rs312 based on PER of 14x FY11E (at 10% discount to market) on EPS (ex-Indus) of Rs22.3 and (ii) Indus stake vale of Rs55/share. We switch over to a PER valuation method as DCF is more back-ended and given the competitive concerns, investors are likely to focus more on near-term earning drivers. The core business value of Rs312 imputes a reasonable EV/EBITDA of 6.6x FY11E.

Risks

Our quantitative risk-rating system, which tracks 260-day share price volatility, rates Bharti shares as Low Risk. We are comfortable with this for the following reasons: 1) Bharti has a track record of profitability and execution; 2) strong balance sheet with low leverage levels (FY10 net debt/EBITDA at 0.2x); and 3) FCF positive in FY10E with major capex behind.

Downside risks include competition-led tariff pressures, excessive bidding for 3G and any adverse regulation. Upside risk could emerge from faster than expected consolidation and sharper than expected pullback in MOUs.

Appendix A-1

Analyst Certification

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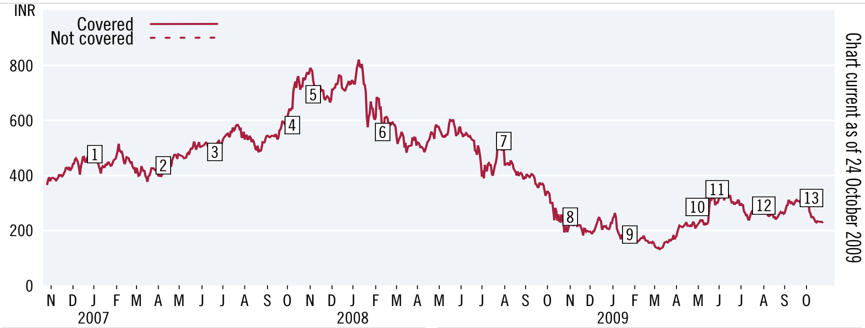
IMPORTANT DISCLOSURES

Reliance Communications (RLCM.BO)

Ratings and Target Price History
Fundamental Research
Analyst: Rahul Singh



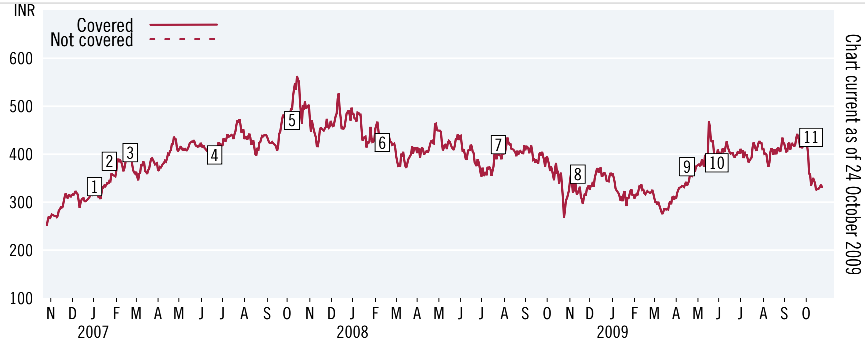
	Date	Rating	Target Price	Closing Price
1	2-Jan-07	1M	*570.00	470.75
2	9-Apr-07	1M	*510.00	415.60
3	20-Jun-07	1M	*600.00	505.90
4	8-Oct-07	*1L	*750.00	640.90
5	6-Nov-07	*2L	*835.00	745.40
6	12-Feb-08	*1L	*760.00	575.70
7	31-Jul-08	*2L	*530.00	500.05
8	2-Nov-08	*2H	*270.00	220.70
9	26-Jan-09	*3H	*150.00	160.15
10	30-Apr-09	3H	*190.00	214.95
11	28-May-09	3H	*270.00	297.35
12	2-Aug-09	*2M	*310.00	275.65
13	8-Oct-09	*3M	*210.00	246.30

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

Bharti Airtel (BRTI.BO)

Ratings and Target Price History
Fundamental Research
Analyst: Rahul Singh



	Date	Rating	Target Price	Closing Price
1	2-Jan-07	1L	*375.00	316.50
2	23-Jan-07	1L	*400.00	344.58
3	21-Feb-07	1L	*480.00	403.15
4	20-Jun-07	1L	*525.00	412.33
5	8-Oct-07	1L	*600.00	492.40
6	12-Feb-08	1L	*575.00	427.90
7	24-Jul-08	1L	*535.00	398.98
8	13-Nov-08	1L	*450.00	315.63
9	16-Apr-09	1L	*420.00	334.38
10	28-May-09	1L	*465.00	397.60
11	8-Oct-09	*2L	*370.00	334.65

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

Rahul Singh, Analyst, holds a long position in the securities of Bharti Airtel.

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Data current as of 30 Sep 2009	**Buy**	**Hold**	**Sell**
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% of companies in each rating category that are investment banking clients	47%	45%	36%

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