

Company Flash

31 October 2007 | 7 pages

Reliance Communications (RLCM.BO)

Buy: 2QFY08 – Wireless Performs Better Than Peers

- **RCOM's 2Q driven by wireless** — RCOM's EBITDA at Rs19.6bn (up 8.1%qoq) was slightly below estimates. Wireless business outperformed the peers and the "lowered" expectations but was offset by the lackluster Global Business, which was again affected by rupee appreciation.
- **Wireless performance was relatively stable** — Revenue growth of 10%qoq, flat rev/min and ARPU decline of only 4%qoq was better than that reported by peers, though MOU decline was expected. In addition, higher net revenue growth of 14%qoq indicates materially higher % of on-net calls during 2Q. Though reported wireless margins improved 20bps, there was Rs280m (75bps) increase in losses in "Other" segment, which captures handset subsidies.
- **Global business was hit by rupee again** — NLD volume growth of 4% and ILD 6%qoq was stable but not spectacular. However, EBITDA from Global Business was flat possibly on account of the impact of rupee appreciation especially on FLAG related revenues and incoming ILD.
- **Step-up in capex, await further details on GSM** — RCOM increased mobile capex significantly from Rs15bn in 1Q to Rs50bn in 2Q, in-line with its stated objective of enhancing CDMA coverage. Increasing visibility on GSM plans (post DOT decision and today's TEC report) and the evolving legal challenges need to be monitored. We await more details in the earnings call tomorrow.

Buy/Low Risk	1L
Price (31 Oct 07)	Rs771.95
Target price	Rs750.00
Expected share price return	-2.8%
Expected dividend yield	0.1%
Expected total return	-2.7%
Market Cap	Rs1,582,049M US\$40,245M

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

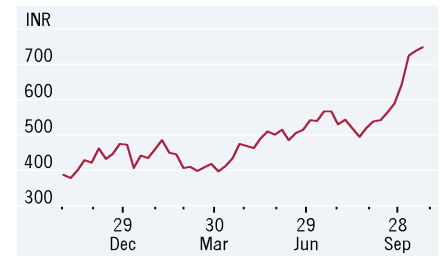


Figure 1. Results Summary

Rs m	Jun-06	Sep-06	Dec-06	Mar-07	Jun-07	Sep-07	Q/Q%	Y/Y%
Net Revenues	32,501	35,260	37,553	39,369	43,037	45,785	6.4	29.8
Access and IUC	(6,489)	(6,087)	(6,356)	(6,696)	(6,076)	(5,837)	(3.9)	(4.1)
Other operating exp	(11,153)	(12,666)	(12,791)	(13,040)	(15,208)	(16,421)	8.0	29.6
License Fees	(2,797)	(2,981)	(3,135)	(3,281)	(3,611)	(3,909)	8.3	31.1
EBITDA	12,062	13,526	15,272	16,352	18,142	19,618	8.1	45.0
PBT	5,549	7,233	9,404	10,366	13,224	13,989	5.8	93.4
PAT	5,277	7,169	9,274	10,217	12,193	13,291	9.0	85.4

Source: Company reports

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Figure 2. QoQ decline in operating metrics vs. Bharti and Idea

	RCOM	Bharti	Idea
ARPU	-3.7%	-6.2%	-10.0%
MOU	-3.9%	-1.9%	-5.5%
Rev/min	-0.3%	-4.5%	-4.8%
EBITDA/min	0.3%	-3.6%	-10.3%

Source: Citi Investment Research

Figure 3. Wireless Summary

Rs m	Jun-06	Sep-06	Dec-06	Mar-07	Jun-07	Sep-07	Remarks
Wireless Revenue	24,320	25,744	27,520	29,692	33,730	37,230	10%qoq growth best among peers
Net Revenue							14%qoq growth in net revenues led by higher on-net proportion
Wireless EBITDA	16,544	17,998	19,308	20,673	24,244	27,722	
Wireless EBITDA margin (%)	8,746	9,294	10,293	11,511	13,392	14,873	
ARPU	36.0	36.1	37.4	38.8	39.7	39.9	Scale economies help in slight margin expansion but
MoU	379	354	328	377	375	361	4% decline lower than peers
Pre-paid as % of net adds	491	461	454	541	510	490	Impact of lifetime less than GSM peers
Non-voice revenue %	80.0	94.6	92.3	96.3	97.0	99.2	Ongoing trend
	6.2	6.3	6.3	6.3	5.7	6.2	
Minutes of usage (bn min)	31.4	33.5	38.1	42.5	45.8	50.7	Robust increase in network usage
Revenue per min (Rs)	0.77	0.77	0.72	0.70	0.74	0.73	Reasonably stable yields were the key
EBITDA per min (Rs)	0.28	0.28	0.27	0.27	0.29	0.29	
Capex per min	4.9	7.2	2.6	2.2	4.5	10.1	Higher on account of accelerated rollout

Source: Citi Investment Research

Figure 4. Global Business Summary

Rs m	Jun-06	Sep-06	Dec-06	Mar-07	Jun-07	Sep-07	Remarks
NLD mins (m)	3,085	4,339	4,715	4,873	5,639	5,853	
ILD mins (m)	1,214	1,361	1,472	1,503	1,590	1,688	Volumes recover in 2Q
Global Business Revenue	12,340	13,158	13,335	12,938	13,033	13,161	Impacted by rupee appreciation
Global Business EBITDA	2,842	3,199	3,552	3,121	3,239	3,276	Lackluster performance
Global Business EBITDA margin (%)	23.0	24.3	26.6	24.1	24.9	24.9	
Net retention per LD min (Rs)	0.67	0.60	0.55	0.55	0.55	0.55	

Source: Citi Investment Research

Figure 5. Broadband Business Summary

Rs m	Jun-06	Sep-06	Dec-06	Mar-07	Jun-07	Sep-07	Remarks
Broadband revenues	2,271	2,710	3,161	3,299	3,833	4,371	
Broadband EBITDA	882	1,215	1,486	1,611	1,836	2,102	
Broadband EBITDA margin (%)	38.8	44.8	47.0	48.8	47.9	48.1	
ARPL (Rs)	2618	2420	2206	1932	1929	1948	Focusing on quality of subs
Towns active (wireline only)	30	30	30	40	42	42	
Bldgs directly connected (nos)	180,759	269,676	379,000	488,661	593,805	666,368	Sustained pace of rollout

Source: Citi Investment Research

Reliance Communications

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. It plans to launch IPTV and retail broadband in 2007. 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 Buy/Low Risk (1L). Continued expansion of the wireless market and RCOM's ability to capture its due market share profitably will, in our view, be a recurring theme. The wireless business has shown higher operating leverage recently and has maintained return parameters despite lower revenue yields. Competitive pressures, though intense, should continue to be rational. RCOM is planning a GSM overlay on its existing CDMA network; while there is market rationale for this (GSM ecosystem more supportive for developing markets), we think the economic rationale would be determined by the deal from vendors as well as the extent of infrastructure-sharing possible. Most regulatory concerns appear behind, and news flow is likely to be positive. The company has yet to realize the benefits of full utilization of its network infrastructure (especially in broadband); we expect significant strengthening of margins as traffic increases across segments. We expect RCOM to register an EBITDA CAGR of 34% and EPS CAGR of 37.2% for FY07-10E.

Valuation

Our 12-month forward target price of Rs750 is based on the core business, valued at Rs660, towerco option value of Rs70, and Flag's potential value unlocking at Rs20. We value Indian wireless plays on DCF given the back-ended nature of profits and cash flow. For RCOM, however, we use EV/EBITDA in the absence of a detailed balance sheet. Our 12-month target price of Rs660 is based on 12.0x FY09E EV/EBITDA, a 5% discount to Bharti's target multiple (ex- towerco). Higher-than-average earnings growth (CAGR of 36% over FY07-10E) and low sensitivity of wireless demand to interest rates should continue to support premium valuations for the sector.

Risks

Our risk-rating system, which tracks 260-day share price volatility, assigns a High Risk rating to RCOM, but we believe Low Risk is more appropriate. RCOM has been de-merged from Reliance Industries, and its shareholding at the time of listing mirrored the holding of RIL. The stock is therefore unlikely to have risks that are typical of newly listed companies. Besides, growth in the telecoms sector gives visibility to RCOM's prospects. Downside risks to our target price include smaller-than-expected market share, lower-than-anticipated operating leverage (especially in FY07) due to handset subsidies, cost-overruns in GSM overlay, regulatory and competition risks, unremunerative capex and delays in the ongoing re-organization and more telecom-related paper.

Appendix A-1

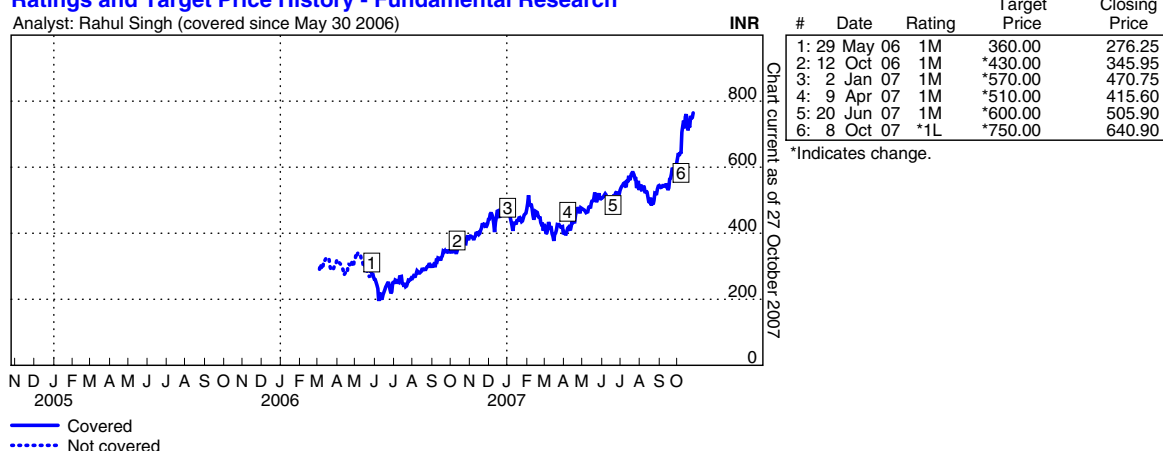
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Analyst: Rahul Singh (covered since May 30 2006)



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31 October 2007

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