23 July 2009 | 8 pages

# IDEA Cellular (IDEA.BO)

Equity

## Sell: 1Q Follows The Trend; Weak MOU, Higher Margins, Churn Up

- **In-line EBITDA despite lower revenue growth** — Idea's 1QFY10 EBITDA at Rs7.7bn (+8% yoy, +4% qoq) came exactly in-line with expectations. The slight disappointment in top-line (net revenue growth of 5.3% qoq, in-line with Bharti) was offset by the 80bps EBITDA margin expansion. Margins expanded as a result of termination cut and relatively stable SG&A. However, PAT was slightly ahead due to lower depreciation and finance charges (attributable to forex gains), although the tax rate at 5% came in higher than expected.

- **KPI trend was in line with Bharti** — 5p rev/min decline was as expected, with termination cut contributing 3p. However, MOU dipped 1% qoq, likely due to the competition's free min offer and slower usage ramp up of rural subs. Overall, ARPUs dipped 9% qoq, with half of that coming from the termination fee cut.

- **Churn continues to go up** — Pre-paid churn continued to rise, reaching an alarmingly high level of 6.9% in 1Q (5.3% in 4Q). The increase was much higher than that witnessed for Bharti (3.2% going to 3.5%) and is possibly a reflection of new circles in Idea's footprint. Incidentally, Spice's churn was even higher at 9.1% in the quarter.

- **New launches had limited impact on EBITDA, will be a drag in 2Q** — EBITDA losses in new circles (TN, Orissa launched in 1Q in addition to the existing new circles of Mumbai/Bihar) remained stable qoq. However, the full impact of new launches will only be felt in 2Q as: (i) the TN launch was in mid-1Q, and (ii) higher rollout increases the costs gradually over 3-6 months from the launch.

| **Sell/Medium Risk** | **3M** |
|---|---|
| Price (23 Jul 09) | Rs77.80 |
| Target price | Rs80.00 |
| Expected share price return | 2.8% |
| Expected dividend yield | 0.0% |
| **Expected total return** | **2.8%** |
| Market Cap | Rs241,187M |
| | US$4,981M |

**Price Performance (RIC: IDEA.BO, BB: IDEA IN)**


**Figure 1. Idea Cellular — Quarterly Summary**

| RsM | Jun-08 | Sep-08 | Dec-08 | Mar-09 | Jun-09 | *QoQ growth* | *YoY growth* |
|---|---|---|---|---|---|---|---|
| **Total Income** | **21,734** | **22,992** | **26,209** | **28,626** | **28,883** | ***0.9%*** | ***32.9%*** |
| Total Opex | (14,578) | (16,968) | (19,404) | (21,211) | (21,183) | *-0.1%* | *45.3%* |
| *EBITDA* | *7,156* | *6,024* | *6,805* | *7,415* | *7,700* | *3.8%* | *7.6%* |
| *EBITDA Margin %* | *32.9%* | *26.2%* | *26.0%* | *25.9%* | *26.7%* | *0.8%* | *-6.2%* |
| Depreciation | (2,749) | (3,032) | (3,579) | (3,897) | (4,064) | *4.3%* | *47.8%* |
| EBIT | 4,407 | 2,992 | 3,226 | 3,518 | 3,636 | *3.4%* | *-17.5%* |
| Net interest exp | (1,526) | (1,497) | (600) | (491) | (406) | *-17.3%* | *-73.4%* |
| PBT | 2,927 | 1,540 | 2,626 | 3,027 | 3,230 | *6.7%* | *10.3%* |
| *Tax* | *(297)* | *(99)* | *(64.0)* | *5.0* | *(156.0)* | *NM* | *NM* |
| **PAT** | **2,630** | **1,441** | **2,562** | **3,032** | **3,075** | ***1.4%*** | ***16.9%*** |

Source: Company Reports, Citi Investment Research and Analysis

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

**Figure 2. KPI Summary**

| | Jun-08 | Sep-08 | Dec-08 | Mar-09 | Jun-09 | CIRA Comments |
|---|---|---|---|---|---|---|
| ARPU | 280 | 263 | 268 | 255 | 232 | Half of the decline relates to termination cut |
| VAS as % of revenue | 8.9% | 9.8% | 9.5% | 9.6% | 10.1% | |
| MOU | 431 | 421 | 416 | 402 | 399 | Slight decline vs. flat expectations |
| Revenue per min | 0.65 | 0.62 | 0.64 | 0.63 | 0.58 | 3p relates to termination cut |
| Subscribers ('000) | 27,194 | 30,380 | 34,211 | 38,889 | 42,769 | |
| Pre-paid as % of total | 93.7% | 94.0% | 94.3% | 94.6% | 95.1% | |
| Total MOU (mn min) | 33,087 | 36,315 | 40,254 | 44,224 | 48,729 | 10% qoq growth, in-line with previous quarters |
| Post-paid churn % | 2.5% | 2.5% | 2.7% | 3.0% | 2.9% | |
| Pre-paid churn % | 4.1% | 4.0% | 4.4% | 5.3% | 6.9% | |
| Blended Churn % | 4.2% | 3.9% | 4.3% | 5.2% | 6.7% | Sharp jump in churn |

Source: Company Reports, Citi Investment Research and Analysis Estimates

**Figure 3. Coverage Details**

| | Jun-08 | Sep-08 | Dec-08 | Mar-09 | Jun-09 | CIRA Comments |
|---|---|---|---|---|---|---|
| Cell sites (excl. Spice) | 27,594 | 33,377 | 39,289 | 44,230 | 48,067 | |
| Cell sites added | 2,801 | 5,783 | 5,912 | 4,941 | 3,837 | Trend similar to Bharti; to sweat the assets more |
| Rent paying sites | 12,903 | 16,628 | 21,459 | 36,573 | 40,211 | |
| Indus component | | | 14,056 | 25,150 | 27,081 | |
| % of rent paying sites | 46.8% | 49.8% | 54.6% | 82.7% | 83.7% | Sustained increase in percent of rent paying sites |

Source: Company Reports, Citi Investment Research and Analysis Estimates

**Figure 4. New Circles Break-Up**

| | Jun-08 | Sep-08 | Dec-08 | Mar-09 | Jun-09 | CIRA Comments |
|---|---|---|---|---|---|---|
| Revenue (New circles) | 1,439 | 52 | 483 | 985 | 1,427 | |
| EBITDA (New circles) | (154) | -337 | -765 | -654 | -644 | Full impact of TN/Orissa launch should reflect in 2Q |
| EBITDA margin (New circles) - % | -10.7% | -648.1% | -158.4% | -66.4% | -45.1% | |
| EBITDA (Old circles) | 7,357 | 6,405 | 7,570 | 8,069 | 8,345 | |
| EBITDA margin (old) - % | | | 29.4% | 29.2% | 30.4% | 120bps margin expansion |

Source: Company Reports, Citi Investment Research and Analysis Estimates

# IDEA Cellular (IDEA.BO; Rs77.80; 3M)

## Company description

Idea Cellular, a pure-play wireless provider, is the fifth-largest cellular operator in India. It has licenses to provide cellular-phone services in all of India's 22 telecom circles and an active presence in 14 of them. The company listed on the Indian bourse in March 2007 and is part of the Aditya Birla Group.

## Investment strategy

We rate Idea Sell/Medium Risk (3M). Inclusion in MSCI and relatively cleaner positioning (post Bharti's MTN agenda) could technically benefit Idea. However, smaller relative scale makes it more vulnerable if competition worsens further and makes too much of compromise on valuation risky. We believe that Idea's current valuation, at premium to Bharti, is rich and more than factors the technical benefit to Idea due to its pure-play positioning. Idea's B/S also remains exposed to 3G outgo especially with the delay in auction and improving credit markets.

## Valuation

Our target price of Rs80 is based on a core business value at Rs59/share and its 16% stake in Indus is valued at Rs21/share. We value core business at 7.8x FY10E EV/EBITDA, a 15% discount to Bharti's imputed target FY10E EV/EBITDA. Our 20% discount reflects easing risks on the B/S due to improving credit environment as well as the perceived increase in risk on Bharti post-MTN. However, we believe some discount to Bharti is justified given 1) Idea's smaller scale makes it more vulnerable to worse-than-expected competitive intensity, 2) its B/S remains most at risk to an aggressive 3G bidding esp. with delay in 3G auction and improving credit markets, and 3) our cautious stance on Idea's ability to generate positive NPV in the new circles.

## Risks

We assign a Medium Risk rating to IDEA Cellular, as opposed to the High Risk assigned by our quant risk rating system due to: 1) Idea has demonstrated strong execution skills in new launches (Mumbai & Bihar) and operating leverage in the 11 old circles; 2) Risk of disruptive pricing from new entrants continues to decline; 3) Improving credit markets helped reduce concerns on the high-leverage balance sheets like Idea Cellular's. Upside risks to our target price include any move by Axiata to announce the tender offer, higher-than-expected market share gains, faster EBITDA breakeven in new circles and moderate 3G bidding. Several downside risks could impede the stock from reaching our target price. Operationally, higher-than-expected competition will impact Idea more than peers given its smaller scale. A prolonged EBITDA breakeven in new circles raises concerns on NPV accretion. In addition, the upcoming 3G auction carries an event risk of unduly straining the balance sheet (FY10E Net Debt/EBITDA already at 2.3x) if bidding is aggressive.

# Bharti Airtel (BRTI.BO; Rs813.90; 1L)

## Valuation

Our target price of Rs930 is based on Sep-09E core DCF of consolidated cash flows incl. the proportionate stake in towerco. The DCF is based on a WACC of 11.3% to reflect the current interest rate environment, reduced country risk premium but offset slightly by MTN specific risk, a terminal growth rate of 4%, and beta of 0.9. We prefer DCF as our primary valuation methodology because the wireless market will likely continue to see robust growth requiring upfront capex but should generate significant free cash beyond FY10E. Our target price represents a FY10E P/E of 18.5x (slight premium to broader market), P/CEPS of 11.1x and EV/EBITDA of 10.1x.

## 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 0.45x); and 3) likely to turn FCF positive in FY10E with major capex behind. Industry risks that could prevent the stock from reaching our target price include competition-led tariff pressures, excessive bidding for 3G and any adverse regulation. Company-specific risks include any modification in the MTN deal structure leading to change in pricing and funding requirement

# Appendix A-1

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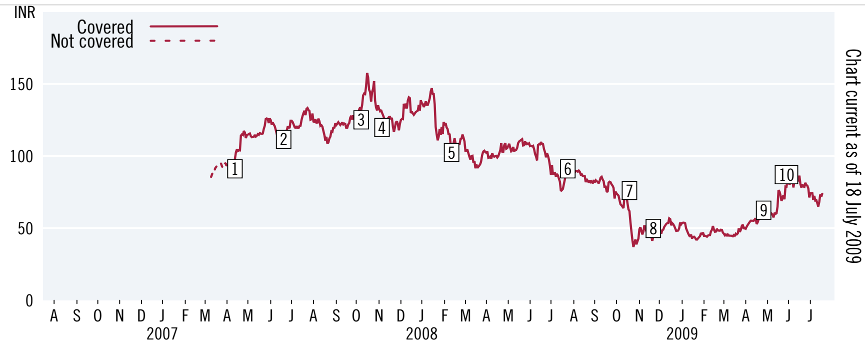
**Fundamental Research**

Analyst: Rahul Singh
Covered since April 12 2007




| | Date | Rating | Target Price | Closing Price |
|---|---|---|---|---|
| 1 | 12-Apr-07 | *1L | *112.00 | 98.15 |
| 2 | 20-Jun-07 | 1L | *140.00 | 115.15 |
| 3 | 8-Oct-07 | 1L | *155.00 | 131.80 |
| 4 | 6-Nov-07 | *2L | *140.00 | 130.10 |
| 5 | 12-Feb-08 | *1L | 140.00 | 106.25 |
| 6 | 24-Jul-08 | 1L | *120.00 | 87.65 |
| 7 | 20-Oct-08 | *2M | *70.00 | 61.80 |
| 8 | 21-Nov-08 | *2H | *56.00 | 44.20 |
| 9 | 26-Apr-09 | *2M | *67.00 | 60.55 |
| 10 | 28-May-09 | *3M | *80.00 | 78.65 |

* Indicates change

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