

Knee-jerk reaction in market irrational...

Telecom stocks have declined an average by 14-18% in the last two days. This can be seen as a thoughtless reaction to recent developments in the market. RCom's new talk plan 'Simply Reliance' has triggered fears of a prospective price war and Trai's suggestion of per second pricing has led to fears of eroding profitability in the whole telecom sector. Our analysis, however, shows that the market reaction is unwarranted and we may see a pull back in telecom stocks.

RCom's Simply Reliance Plan

Reliance Communication yesterday launched a new plan 'Simply Reliance' wherein all calls and sms (except international and data), whether local or STD would be charged at Rs 0.50/minute. Prepaid customers would be required to pay a one-time migration charge of Rs 48 to use this plan while post-paid subscriber would have to pay a monthly rental of Rs 99. This plan, however, would result in the average revenue per minute (ARPM) declining from Rs 0.57 to Rs 0.35. The company may gain subscribers in the short-term. However, it may not translate into revenue and earnings growth. Our analysis shows that the additional subscriber growth may be set off by declining ARPM, resulting in overall decline in profitability. Also, we do not expect other incumbents to react to this offer.

Per second billing

Chairman of Telecom Regulatory Authority of Indian (Trai), JS Sharma yesterday indicated at making it mandatory for telecom operators to introduce plans based on per second pricing along with current plans. However, he did not mention any timeframe for implementation of the same. Moreover, our analysis shows that it may not be equally harmful for all operators. Although, per second billing will squeeze the margins and result in lower profitability, it will also induce higher tendency to talk resulting in rapid subscriber growth and increase in minutes of usage (MoU) or seconds of usage. This would lead to overall volume growth in the industry.

Outlook & valuation

All telecom stocks have declined an average of 14-18% in the last two days. We believe this is a knee-jerk reaction to recent market developments and expect valuations to rise in due course. We believe fundamentals of the telecom sector are still strong and there is ample opportunity for growth. In light of current events we have revised our estimates for all telcos. In cognizance of recent market panic we have done away with the premium earlier assigned to telecom stocks. We value Bharti Airtel at Rs 455 and rate it as **OUTPERFORMER**. We value RCom and Idea at Rs 254 and Rs 68, respectively, and rate both as **HOLD**.

Exhibit 1: Key Financials

	CMP	TP	M Cap Rs Cr.	EPS (Rs)			P/E (x)			EV/EBITDA (x)		
				FY09	FY10E	FY11	FY09	FY10E	FY11E	FY09	FY10E	FY11E
Bharti Airtel*	354	455	134395	22.3	24.7	29.2	15.9	14.3	12.1	9.5	8.3	6.7
RCOM	268	254	55316	28.6	21.4	22.2	9.4	12.5	12.1	9.3	10.0	8.1
Idea	63	68	20946	2.9	3.9	4.4	21.8	16.3	14.4	7.6	7.6	6.2

*FY09 EPS adjusted after stock split

Source: Company, ICICIdirect.com Research

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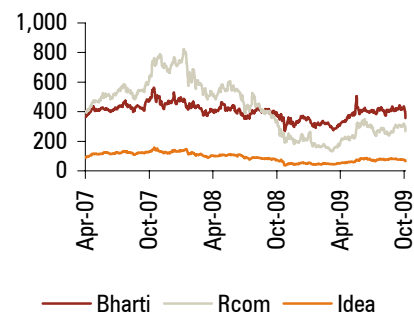
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Price performance (%)

	1M	3M	6M	12M
Bharti Airtel	11.5	-0.1	42.0	2.8
RCOM	20.1	-13.4	129.1	-24.9
Idea	6.7	-5.0	75.4	-8.2

Price chart



* Bharti stock price after stock split

Simply Reliance Plan

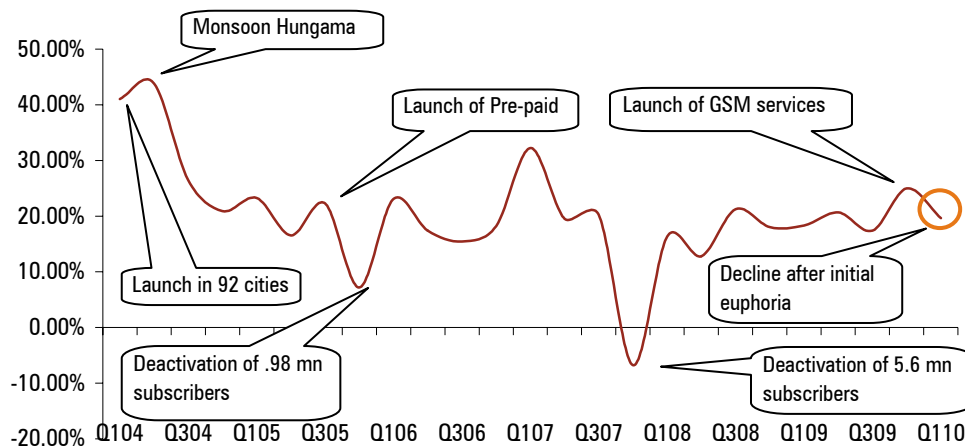
RCom's new plan may result in a spike in subscriber addition. However, like earlier offers we expect the subscriber addition to settle down and decline to traditional levels of 2.3-2.5 million per month in due course. A case in point is the company's earlier offers explained below:

Case Study: Past offers

Stunning net adds but end result not very productive...

The company offered a revolutionary introductory tariff structure, which redefined the pricing strategy in the mobile industry. With commercial launch on a large scale in May 2003 and launch of 'Monsoon Hungama' in July 2003 the company attained a net add share of above 40% in both Q104 and Q204. Within seven months of launch, it became the largest service provider in the country.

Exhibit 2: RCom's share of net adds



Earlier two aggressive launches have resulted in huge churn at a later date. This time as well, we expect RCOM to report huge churn, going forward

Source: Company, ICICIdirect.com Research

However, with aggressive pricing the company was unable to check the subscriber quality. Eventually, it had to deactivate about 0.98 million subscribers in March 2005 on account of creditworthiness and another 5.58 million in March 2007 due to stricter verification norms.

Similarly, the share in net adds has started to decline after the launch of the GSM offer. We do not expect a significant change in industry dynamics this time also. Moreover, we are wary about the subscriber growth momentum and expect a significant churn, going forward.

The new pricing plan by Reliance Communication would translate into an ARPM of Rs 0.35 per minute. However, the management indicated that realisations per minute are unlikely to fall below Rs 0.50 in the industry. We do not expect all subscribers to shift to the new plan. Moreover, there would be additional earnings from VAS and international calling.

Exhibit 3: Impact of Simply Reliance on ARPM

	Existing Plan	Simply Reliance
Minutes of Usage	357	357
Incoming (%)	50	50
Outgoing (%)	50	50
Local (%)	85	85
STD (%)	15	15
Tariff		
Incoming Call	0.2	0.2
Local Outgoing on net	1	0.5
off net	1	0.5
STD outgoing on net	1.5	0.5
off net	1.5	0.5
Revenue		
Incoming Call	35.7	35.7
Local Outgoing	151.7	75.9
STD Outgoing	40.2	13.4
Total Revenue	227.6	125.0
ARPM	0.64	0.35

The new pricing plan by Reliance Communications would translate into an ARPM of Rs 0.35 per minute. However, the management indicated that realisations per minute are unlikely to fall below Rs 0.50 in the industry

Source: Company, ICICIdirect.com Research

We have not assumed such a sharp decline in ARPM but have reduced them by 4.2% and 7.0% for FY10E and FY11E respectively. However, we expect the pace of subscriber addition to hasten a little bit. We have revised our estimates for RCom based on current events.

Exhibit 4: Key assumptions

Key Assumptions		FY10E			FY11E		
		Old	Revised	Diff (%)	Old	Revised	Diff (%)
Subscribers	Mn	96.1	100.1	4.2	117.3	124.3	6.0
ARPM	Rs	0.54	0.52	-4.2	0.51	0.47	-7.2
ARPU	Rs	198.3	187.6	-5.4	181.2	168.5	-7.0
MOU	Minutes	365.1	360.8	-1.2	357.8	358.6	0.2

Source: Company, ICICIdirect.com Research

Exhibit 5: Estimate revision

Estimates	FY10E			FY11E		
	Old	Revised	Diff (%)	Old	Revised	Diff (%)
Revenue	25,270.8	24,678.8	-2.3	29,515.0	28,932.9	-2.0
EBITDA	9,415.2	8,563.7	-9.0	11,635.0	10,643.4	-8.5
% Margin	39.1	36.6	-6.2	40.8	38.3	-6.2
PAT	4,845.7	4,422.1	-8.7	4,976.4	4,578.1	-8.0
EPS	23.5	21.4	-8.7	24.1	22.2	-8.0

Source: Company, ICICIdirect.com Research

Pricing war looks unlikely

ARPM of Rs 0.35 is not a sustainable idea even for incumbent players and we do not expect large players to react to this offer. RCom management's indication of ARPM not falling below Rs 0.50 also suggests that the pricing strategy is not fully clear. Moreover, Bharti Airtel's management has reiterated that it would not join the pricing war and would look at leveraging its brand value and triple play proposition to maintain leadership in the wireless domain.

At best the company's new offer would hasten the consolidation in the industry by making it unviable for new players to sustain on a price based offering. Although there will be a short-term impact on revenue/profitability, we believe this is beneficial for the long-term prospects of the industry.

Valuations

We have valued RCom on a DCF methodology. Assuming revenue CAGR of 9.5% over FY10E-20E, WACC of 13.7% and terminal growth of 3.05, we have arrived at a target price of Rs 254 per share for Reliance Communications.

Exhibit 6: DCF assumptions

Rs in Crore

WACC	13.71%
Revenue CAGR over FY10E-20E	9.5%
Present Value of Cash Flow till FY19E	33,929.71
Terminal Growth	3.0%
Present Value of terminal cash flow	42,903.30
Total present value of the firm	76,833.01
Less: Current Debt	33,552.00
Total PV of the Equity (ex current cash)	43,281.01
Number of Equity Shares outstanding	206.40
Per Share Value (excluding current cash)	209.69
Add Current Cash Per Share	44.46
DCF - Target price (Rs)	254.15

Source: Company, ICICIdirect.com Research

Our target price discounts RCom's revised FY10 EPS of Rs 21.4 and FY11 EPS of Rs 22.2 by 11.9x and 11.5x, respectively. This is an approximately 28% discount to Bharti Airtel.

Per second billing

Chairman of Trai, JS Sharma, indicated making it mandatory for telecom operators to introduce plans based on per second pricing along with current plans.

"We plan to ask operators to charge customers on a per-second basis so that consumers can enjoy the benefit of paying only for their usage,"
JS Sharma

However, he did not mention any timeframe for implementation of the same. He also indicated at releasing a consultation paper and would take the suggestions of the incumbent operators before coming to any conclusion. We believe, this could take more than six months in the current scenario.

"We will first issue a consultation paper on the subject. According to existing regulations, Trai can issue a directive only after seeking the industry's view on the subject,"...Mr. J.S. Sharma

Moreover, our analysis shows that it may not be equally harmful for all the operators. Though, per second billing will squeeze the margins and result in lower profitability, it will also induce higher tendency to talk resulting in rapid subscriber growth and increase in MoU or seconds of usage. This would lead to overall volume growth in the industry.

Exhibit 7: Impact on Bharti Airtel

Duration of Per call (seconds)	40		45		50		Status Quo	
	FY10E	FY11E	FY10E	FY11E	FY10E	FY11E	FY10E	FY11E
Assumed Revenue/Unit	1 paisa/sec	1 paisa/sec	1 paisa/sec	1 paisa/sec	1 paisa/sec	1 paisa/sec	Rs 0.56/min	Rs 0.53/min
ARPU	214.9	196.8	233.8	221.4	252.8	246.0	290.7	281.5
Revenue	35233.4	39795.0	37601.7	43576.7	39970.0	47358.4	41059.2	46971.7
EBITDA	13141.7	14742.3	14630.5	17114.2	16119.3	19486.2	16730.4	19561.1
% Margin	37.3	37.0	38.9	39.3	40.3	41.1	40.7	41.6
PAT	6,402.5	7,129.3	7,642.7	9,085.0	8,882.8	11,040.7	9,391.8	11,102.5
EPS	16.9	18.8	20.1	23.9	23.4	29.1	24.7	29.2
Decline in EPS	-31.8%	-35.8%	-18.6%	-18.2%	-5.4%	-0.6%	-	-

Source: Company, ICICIdirect.com Research

Exhibit 8: Impact on Reliance Communication

Duration of Per call (seconds)	38		42		45		Status Quo	
	FY10E	FY11E	FY10E	FY11E	FY10E	FY11E	FY10E	FY11E
Assumed Revenue/Unit	1 paisa/sec	1 paisa/sec	1 paisa/sec	1 paisa/sec	1 paisa/sec	1 paisa/sec	Rs 0.54/min	Rs 0.50/min
ARPU	163.8	142.2	176.1	157.2	185.3	168.4	220.2	179.7
Revenue	22,088.0	24,952.9	23,270.8	26,778.7	24,158.0	28,148.1	24,678.8	28,932.9
EBITDA	7,541.2	8,848.0	8,077.5	9,707.5	8,479.6	10,352.2	8,563.7	10,643.4
% Margin	36.3	37.2	36.8	37.9	37.1	38.3	36.6	38.3
PAT	3,523.2	3,065.5	3,992.4	3,809.4	4,344.2	4,367.3	4,422.1	4,578.1
EPS	17.1	14.9	19.3	18.5	21.0	21.2	21.4	22.2
Decline in EPS	-20.3%	-33.0%	-9.7%	-16.8%	-1.8%	-4.6%	-	-

Source: Company, ICICIdirect.com Research

Exhibit 9: Impact on Idea Cellular

Duration of Per call (seconds)	40		43		47		Status Quo	
	FY10E	FY11E	FY10E	FY11E	FY10E	FY11E	FY10E	FY11E
Assumed Revenue/Second	1 paisa/sec	1 paisa/sec	1 paisa/sec	1 paisa/sec	1 paisa/sec	1 paisa/sec	Rs 0.54/min	Rs 0.52/min
ARPU	188.7	165.2	195.3	177.5	204.1	194.1	214.5	197.2
Revenue	11483.4	13178.0	11888.1	14166.4	12427.6	15484.2	13060.4	15732.7
EBITDA	2731.7	2974.7	2946.3	3507.9	3232.3	4218.8	3567.7	4352.8
% Margin	23.8	22.6	24.8	24.8	26.0	27.2	27.3	28.7
PAT	513.9	287.6	709.1	767.5	969.4	1407.3	1287.2	1456.6
EPS	1.6	0.9	2.1	2.3	2.9	4.3	3.9	4.4
Decline in EPS	-60.1%	-80.3%	-44.9%	-47.3%	-24.7%	-3.4%	-	-

Source: Company, ICICIdirect.com Research

We have assumed different average duration of each call for all operators. Our assumptions are based on perceived subscriber quality of each operator based on their respective market and revenue share.

However, we do not expect the profitability to fall drastically even if such pricing strategy is adopted. This is only an indicative scenario and the telecom operators may also look at further rationalising their cost structure in case such a pricing policy is implemented.

It is reasonable to believe that incumbent operators would have more linear cost structure than the new ones and any change in policy, even if harmful for the industry, would harm the new operators more. This implies that incumbents would emerge clear winners after the initial turmoil.

Outlook & valuation

The recent events in the market have caused investors to panic resulting in a 15-18% decline in telecom stocks in the last two days. Although the key metrics may continue to deteriorate, we believe with just about 40% penetration, subscriber growth would continue unabated. This would ensure volume growth resulting in revenue and profitability growth. This panic is irrational and we expect the valuations to come back to reasonable level in due course.

Taking into account recent development in the industry and subscriber addition since our last update we have revised our estimates slightly.

Exhibit 10: Bharti - Estimate Revision

Estimates	FY10E			FY11E		
	Old	Revised	Diff (%)	Old	Revised	Diff (%)
Revenue	41,599.1	41,059.2	-1.3	47,751.7	46,971.7	-1.6
EBITDA	17,289.3	16,730.4	-3.2	20,306.0	19,561.1	-3.7
% Margin	41.56	40.75	-81 bps	42.5	41.6	-88 bps
PAT	9,857.4	9,391.8	-4.7	11,716.7	11,102.5	-5.2
EPS	26.0	24.7	-4.7	30.9	29.2	-5.2

Source: Company, ICICIdirect.com Research

Exhibit 11: Idea - Estimate Revision

Estimates	FY10E			FY11E		
	Old	Revised	Diff (%)	Old	Revised	Diff (%)
Revenue	13,429.4	13,060.4	-2.7	16,007.6	15,732.7	-1.7
EBITDA	3,817.9	3,567.7	-6.6	4,525.3	4,352.8	-3.8
% Margin	28.4	27.3	-111 bps	28.3	27.7	-60 bps
PAT	1,260.2	1,287.2	2.1	1,420.8	1,456.6	2.5
EPS	3.8	3.9	2.1	4.3	4.4	2.5

Source: Company, ICICIdirect.com Research

We had earlier valued Bharti Airtel at a premium of 5% to the benchmark index. Cognizant of the near term industry concerns, now we have not given any premium to the stock. Our target price for Bharti Airtel discounts FY11E EPS of Rs 29.24 by 15.6x, which is at a slight discount to Sensex. Using DCF methodology we maintain our target price of Rs 455 per share for Bharti Airtel. We rate the stock as **OUTPERFORMER** at current price level.

Using DCF methodology, we arrive at a target price of Rs 254 for Reliance Communication. This discounts FY11E EPS of Rs 22.2 by 11.5x. This is a 28% discount to Bharti Airtel. We rate the stock as **HOLD**.

Our revised target price of Rs 68 for Idea Cellular discounts its FY11E EPS of Rs 4.4 by 15.4x. This is in line with the multiple of Bharti Airtel as opposed to a premium of 20% over Bharti Airtel earlier. We rate the stock as **HOLD**.

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Outperformer (OP): 20% or more;

Performer (P): Between 10% and 20%;

Hold (H): $\pm 10\%$ return;

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