

AUGUST 29, 2011

UPDATE

Coverage view: **Cautious**

Price (Rs): **77**

Target price (Rs): **80**

BSE-30: **16,416**

FY2011 annual report analysis, more thoughts. RCOM remains fundamentally challenged with a balance sheet saddled with high debt and a P&L that continues to deteriorate despite the company's aggressive cost-rationalization efforts. Net debt has expanded 3X since FY2008, while EBIT is down 45% - primarily a result of the company's GSM rollout, which is yet to yield desired revenue/EBITDA upside. We cut our EPS estimates for FY2012-14E by 15-24% and lower our end-FY2013E DCF-based target price to Rs80/share (Rs95 earlier). Reiterate SELL.

Company data and valuation summary

Reliance Communications

Stock data

52-week range (Rs) (high,low)	189-72
Market Cap. (Rs bn)	163.8

Shareholding pattern (%)

Promoters	67.9
FIs	9.0
MFs	0.7

Price performance (%)

	1M	3M	12M
Absolute	(24.4)	(9.7)	(52.1)
Rel. to BSE-30	(16.2)	0.5	(47.5)

Forecasts/Valuations

	2011	2012E	2013E
EPS (Rs)	6.3	2.6	5.2
EPS growth (%)	(71.1)	(59.4)	103.2
P/E (X)	12.2	30.0	14.8
Sales (Rs bn)	224.3	223.9	249.7
Net profits (Rs bn)	13.3	5.5	11.1
EBITDA (Rs bn)	84.0	74.3	84.1
EV/EBITDA (X)	6.0	6.4	5.5
ROE (%)	3.2	1.3	2.7
Div. Yield (%)	0.0	0.0	0.0

Multi-year performance deterioration continues

RCOM's FY2011 consolidated revenues of Rs224 bn were just 19% higher than FY2008 levels, a 3-year CAGR of just 6% despite the company rolling out its pan-India GSM network and making a few acquisitions on the non-wireless side in the interim. EBITDA in the same timeframe has grown at a CAGR of <2%, that too aided by the IRU accounting change in FY2011. Annualized 1QFY12 EBITDA is almost 20% lower than FY2008 levels. GSM investments and acquisitions have of course impacted the company's EBIT - FY2011 EBIT was 64% lower than FY2008 levels despite the company having adopted aggressive depreciation policies since. Pre-tax ROCE in FY2011 was just 2%, down from 8% in FY2008.

Net debt continues to go up

RCOM's net debt at end-FY2011 stood at Rs336 bn, up from Rs247 bn at end-FY2010 and Rs25 bn at end-FY2007. We note that the net debt as per the annual report is higher than the Rs319 bn reported in the company's 4QFY11 disclosures. This is likely on account of reclassification of buyer's credit into debt - this is classified as current liability in quarterly reports. Gross debt at end-FY2011 stood at Rs391 bn, of which Rs120 bn was Re-denominated and the balance in foreign currency. We also note that Rs27 bn of capex credit is not included in these debt figures and is classified as current liabilities. Even as capex credit is a normal industry practice, we highlight this as the company has now guided for a low-capex phase - this would mean additional cash flow burden going forward as capex credit declines.

Weak competitive positioning + stretched balance sheet. SELL

We reiterate our SELL rating on RCOM despite the sharp correction in the stock. Low capex (guided FY2012E capex is just 6.7% of estimated revenues), and potential corporate actions to shore up the balance sheet (parent equity dilution, stake sale in subsidiaries) are necessary, but may not be value-accretive. P&L improvement remains critical to long-term balance sheet health - RCOM's weak competitive positioning across business lines makes this a difficult challenge, in our view. Valuations at 5.6X FY2013E EV/EBITDA is not inexpensive, either.

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FY2011 annual report – some observations

Accounting changes continued – two key ones –

- ▶ Change in revenue accounting for long distance IRU sales – the company has now moved to upfront revenue booking versus amortizing sales over the period of the contract earlier. This change had a Rs25.45 bn positive impact on revenues and Rs25.3 bn positive change on EBITDA, while being broadly neutral at the EBIT level. We are surprised that the incremental depreciation on account of this accounting change was equal to (in fact a tad higher than) incremental revenues – one likely inference is that pricing on the company's LD IRU contracts was not even covering capex recovery charges.
- ▶ Depreciation policy – RCOM changed the useful life estimate of network assets again, this time increasing it to 18 years. This change had a positive impact of Rs9.5 bn at the PBT level. Adjusted for this, the company's net income would have been lower by ~30% versus the reported Rs13.5 bn.

Low effective interest cost continues to perplex

Including capitalized interest, RCOM's net interest expense (excluding forex-related items) in FY2011 was Rs13.7 bn, lower in absolute terms versus FY2010 as well as FY2009 despite the sharp increase in net debt since. Effective interest cost (on ex-FCCB debt) was 4.9%, down from 5.6% in FY2010. In fact, if one were to take out the 11.2% secured non-convertible debentures and associated interest from the equation, the effective interest cost on the remainder of the debt works out to an even lower 4.2%.

Aggressive cost rationalization fails to propel profits

RCOM rationalized costs aggressively in FY2011 – all cost-line items, with the exception of interconnect charges (which are partially regulated), were down in absolute terms yoy. Sharpest decline was in network opex (down 9% yoy), and G&A expenses (again down 9% yoy). Nonetheless, despite the cost rationalization, the company saw a 45% yoy dip in EBIT and 71% yoy dip in PBT.

Tax rates (effective as well as cash) continue to be low

RCOM's effective tax rate for FY2011 was a low 1% of PBT, aided by current tax write-back. The company received an income tax refund of Rs5.2 bn during the year.

CWIP remained high at Rs182 bn, up from Rs117 bn at end-FY2010. Even excluding the Rs86 bn 3G spectrum investments, CWIP would have come down by only Rs21 bn to Rs96 bn

Reliance Infratel financials

Reported revenues of Rs66.7 bn showed a 6% yoy uptick, substantially lower than other towercos. EBITDA margins expanded 530 bps qoq to 66.6%. We note the RITL's reported EBITDA margins are higher than average industry levels and likely reflect higher-than-market pricing in RITL's MSA with RCOM. RITL's net income declined 9% yoy despite the 15%+ yoy growth in EBITDA.

Cut estimates and target price

We cut our FY2012E, FY2013E and FY2014E EPS estimate to Rs2.6 (from Rs3.4), Rs5.2 (from Rs6.4) and Rs8.2 (from Rs9.7), respectively. We note that our estimates, which call for a 13.4% 3-year consol EBITDA CAGR through FY2014E may not be conservative. We in fact see downside risks to our revenue/EBITDA estimates. We also reduce our end-FY2013E DCF-based target price on the company to Rs80/share (from Rs95 earlier), implying 5.8X FY2013E EV/EBITDA (again not conservative).

Exhibit 1: Key changes to RCOM earnings model, FY2012-14E, March fiscal year-ends

	Revised			Earlier			Change (%)		
	FY2012E	FY2013E	FY2014E	FY2012E	FY2013E	FY2014E	FY2012E	FY2013E	FY2014E
Consolidated									
Revenues (Rs mn)	223,850	249,707	274,999	223,850	249,707	274,999	-	-	-
EBITDA (Rs mn)	74,295	84,125	95,437	74,295	84,125	95,437	-	-	-
EBIT (Rs mn)	25,394	32,187	40,029	25,511	32,443	40,410	(0.5)	(0.8)	(0.9)
EPS (Rs/share)	2.56	5.20	8.20	3.35	6.38	9.66	(23.5)	(18.5)	(15.2)
EBITDA margin (%)	33.2	33.7	34.7	33.2	33.7	34.7	0 bps	0 bps	0 bps
Capex (Rs bn)	16	45	52	16	45	52	-	-	-
Wireless metrics									
Revenues (Rs mn)	182,400	204,733	227,235	182,400	204,733	227,235	-	-	-
EBITDA (Rs mn)	49,868	57,088	65,574	49,868	57,088	65,574	-	-	-
EBITDA margin (%)	27.3	27.9	28.9	27.3	27.9	28.9	-	-	-
Subs (mn)	163	184	200	163	184	200	-	-	-
Volumes (bn min)	408	443	487	408	443	487	-	-	-
RPM (paise/min)	0.447	0.462	0.467	0.447	0.462	0.467	-	-	-
ARPU (Rs/sub/month)	102	98	98	102	98	98	-	-	-
MOU (min/sub/month)	227	213	211	227	213	211	-	-	-

Source: Kotak Institutional Equities estimates

Exhibit 2: Our March 2013 DCF-based forward value for RCOM is Rs80/share

	2010	2011	2012E	2013E	2014E	2015E	2016E	2017E	2018E	2019E	2020E	2021E
EBITDA	71,852	84,042	74,295	84,125	95,437	105,734	115,737	125,622	137,003	146,474	155,952	165,638
Tax	(2,945)	(3,011)	(1,487)	(2,701)	(4,148)	(5,991)	(7,878)	(9,912)	(12,419)	(14,702)	(17,123)	(19,691)
Change in working capital	(7,642)	(35,330)	(22,324)	(2,607)	(4,455)	(3,736)	(4,512)	(3,959)	(3,511)	(3,077)	(2,846)	(2,731)
Post-tax operating cash flow	61,265	45,702	50,484	78,816	86,834	96,007	103,346	111,752	121,073	128,695	135,982	143,216
Capex	(41,621)	(128,441)	(11,271)	(45,315)	(52,431)	(58,303)	(58,102)	(58,377)	(59,346)	(60,938)	(62,919)	(65,214)
Free cash flow	19,644	(82,740)	39,213	33,501	34,403	37,704	45,245	53,375	61,727	67,756	73,064	78,002
Mar-13												
PV of cash flows	265,009	WACC and terminal year assumptions										
PV of terminal value	218,698	Terminal growth (%)										
EV	483,708	WACC (%)										
Net debt	313,986	3.0										
Equity value (Rs mn)	169,722	15.0										
Equity value (US\$ mn)	3,536											
RCL shares (mn)	2,133											
Equity value (Rs/share)	80											
Exit FCF multiple (X)	8.6											
Exit EBITDA multiple (X)	4.0											
Key assumptions (%)												
Revenue growth	(3.4)	4.3	(0.2)	11.6	10.1	8.3	7.1	6.3	5.6	5.1	4.9	4.7
EBITDA growth	(16.5)	17.0	(11.6)	13.2	13.4	10.8	9.5	8.5	9.1	6.9	6.5	6.2
EBITDA margin	33.4	37.5	33.2	33.7	34.7	35.5	36.3	37.1	38.3	38.9	39.5	40.1
Capex/sales	19.4	57.3	5.0	18.1	19.1	19.6	18.2	17.2	16.6	16.2	15.9	15.8
Effective tax rate	8.5	0.8	5.0	6.0	8.0	10.0	12.0	14.0	16.0	18.0	20.0	22.0
ROCE (%)	4.2	3.0	3.4	4.3	5.4	6.4	7.4	8.5	9.7	10.8	11.9	13.0

Source: Kotak Institutional Equities estimates

Exhibit 3: RCOM income statement analysis, March fiscal-year ends, 2008-2011 (Rs mn)

Rs mn	FY2008	FY2009	FY2010	FY2011	yoy (%)
Revenues	188,274	222,505	214,964	224,304	4
Expenses					
Interconnect expenses	28,197	23,817	21,377	26,476	24
License fees	12,386	11,865	11,451	11,572	1
Network costs	22,008	44,163	59,955	54,716	(9)
Employee costs	11,875	16,728	15,007	14,757	(2)
Selling expenses	22,598	21,208	22,499	21,041	(6)
Of which					
Commission	4,099	3,503	6,699	7,047	5
Cost of sale of telecom terminals	5,092	2,853	5,033	3,246	(36)
G&A expenses	11,461	18,655	12,830	11,699	(9)
Total expenses	108,525	136,435	143,118	140,261	(2)
EBITDA	79,749	86,070	71,846	84,043	17
Depreciation and amortization	28,053	36,077	37,465	65,038	74
EBIT	51,696	49,993	34,381	19,005	(45)
Financial charges	6,458	10,711	(10,932)	11,328	(204)
Financial income	10,455	15,781	932	605	(35)
Of which					
Income from investments and int income	10,455	2,394	932	605	(35)
other financial income	-	13,387	-	-	
Other income	2,404	6,979	6,359	6,773	7
Of which					
Profit on sale of investments	1,695	3,278	2,095	3,886	85
Miscellaneous income	438	3,536	4,264	2,887	(32)
PBT	58,097	62,042	52,603	15,055	(71)
Provision for taxes	2,836	(518)	4,454	118	(97)
Of which					
Current tax	1,981	328	3,725	(2,804)	(175)
PAT before exceptional items	55,261	62,560	48,149	14,937	(69)
Exceptional items	(12,666)	75	375	(121)	(132)
Minority interest	13,901	2,052	1,193	1,503	26
Share of profit/(loss) of associates	15	(16)	32	99	210
Reported PAT	54,011	60,449	46,550	13,457	(71)

Source: Company, Kotak Institutional Equities

Exhibit 4: Reliance Communication's balance sheet, March fiscal-year ends, 2007-2011 (Rs mn)

	FY2007	FY2008	FY2009	FY2010	FY2011	FY2011 reported in 4QFY11 disclosures
Equity						
Share capital	10,223	10,320	10,320	10,320	10,320	10,320
Reserves and surplus	219,083	279,943	412,483	423,286	394,672	347,198
Equity	229,307	290,263	422,803	433,606	404,992	357,518
Minority interest	56	24,309	6,549	6,584	8,245	8,245
Debt	174,383	258,217	391,623	297,154	390,714	373,757
Deferred tax liability	26	1,028	281	991	3,668	-
Current liabilities	114,334	156,213	159,718	147,085	106,018	126,860
Provisions	47,149	44,564	41,096	40,267	33,591	24,901
Total capital	565,254	774,593	1,022,070	925,686	947,227	891,281
Assets						
Cash	72,006	8,782	16,829	8,185	48,663	53,272
Inventories	4,821	4,059	5,428	5,446	5,172	5,172
Debtors	18,316	27,224	39,618	33,117	39,840	40,017
Other current assets	13,884	23,058	17,714	20,726	20,110	11,460
Loans and advances	22,103	42,695	67,557	54,098	50,863	50,863
Gross block	349,442	463,388	755,101	786,653	820,902	820,902
Less: Depreciation	55,926	89,561	141,144	190,671	273,406	273,406
Net block	293,516	373,826	613,957	595,982	547,496	547,496
Capital work in progress	36,907	149,299	113,096	116,557	181,912	181,912
Goodwill	26,588	35,654	52,215	49,976	47,473	
Investments	77,114	109,996	95,656	41,599	5,698	1,089
Total assets	565,254	774,593	1,022,070	925,686	947,227	891,281
Net debt	25,263	139,439	279,138	247,370	336,353	319,396
Net working capital (ex-cash)	(102,358)	(103,741)	(70,497)	(73,964)	(23,624)	(44,249)
Capex creditors				21,608	27,287	
Net debt + capex creditors				268,978	363,640	

Source: Company, Kotak Institutional Equities

Exhibit 5: Sharp decline in cost of debt continues to surprise

Rs mn	FY2007	FY2008	FY2009	FY2010	FY2011
Foreign currency debt	127,144	174,117	243,075	236,197	270,470
FCCB	66,304	54,932	70,835	64,596	66,965
ex-FCCB FC debt	60,840	119,185	172,240	171,602	203,505
Rupee debt	47,240	84,100	148,547	60,957	120,244
Total debt	174,383	258,217	391,623	297,154	390,714
Ex-FCCB total debt	108,079	203,285	320,787	232,559	323,749
Interest expense (a)		10,327	12,118	15,519	10,163
Interest capitalised		599	3,376	—	3,551
Adjusted interest		10,926	15,494	15,519	13,714
Implied interest rate (%)		7.0	5.9	5.6	4.9

Note:

(a) Excluding Fx gains/losses.

Source: Company, Kotak Institutional Equities

Exhibit 6: Reliance Infratel financials

Rs mn	FY2008	FY2009	FY2010	FY2011	Change (yoy)
Revenues	14,576	49,340	62,767	66,738	6.3
Operating costs	(7,821)	(15,538)	(24,275)	(22,306)	(8.1)
EBITDA	6,756	33,802	38,492	44,432	15.4
EBITDA margin (%)	46.3	68.5	61.3	66.6	
Net profit/(loss)	3,206	16,857	9,056	8,263	(8.8)
Total assets	117,205	191,981	164,875	192,906	
Shareholder's equity	51,107	40,368	51,642	72,462	
# of towers	30,295	48,000	49,300	50,000	

Source: Company, Kotak Institutional Equities

Exhibit 7: RCOM's condensed financial statements, March year-ends, 2010-2017E

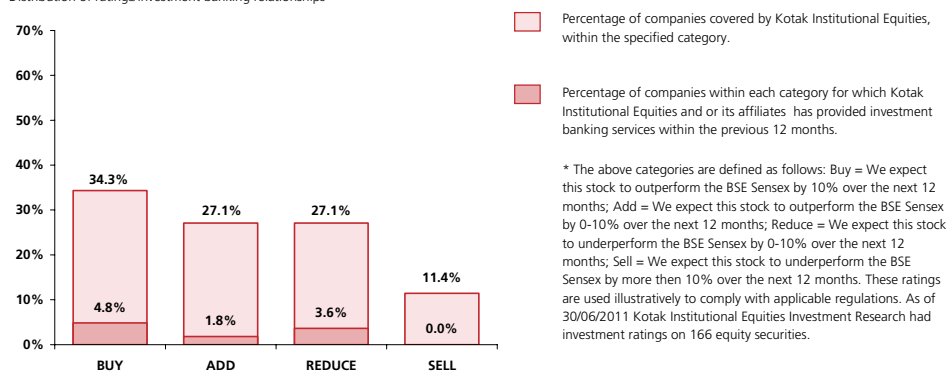
	2010	2011	2012E	2013E	2014E	2015E	2016E	2017E
Profit model (Rs mn)								
Revenue	214,964	224,304	223,850	249,707	274,999	297,782	318,962	338,966
EBITDA	71,852	84,042	74,295	84,125	95,437	105,734	115,737	125,622
EBIT	34,387	19,004	25,394	32,187	40,029	47,900	55,507	63,227
Net interest income / (expense)	18,222	(3,950)	(17,961)	(18,680)	(19,291)	(17,943)	(16,117)	(13,668)
Tax	(4,454)	(118)	(372)	(810)	(1,659)	(2,996)	(4,727)	(6,938)
Net profit	46,899	13,335	5,459	11,095	17,477	25,359	33,061	41,019
Fully diluted EPS	21.8	6.3	2.6	5.2	8.2	11.9	15.5	19.2
Balance sheet (Rs mn)								
Cash	8,185	48,663	46,030	37,742	30,343	23,099	15,378	18,058
Other current assets	113,388	115,984	115,791	126,843	137,653	147,391	156,444	164,995
Fixed assets	712,539	729,409	691,779	685,157	682,180	682,649	680,521	676,503
Other current liabilities	187,351	139,608	117,091	125,536	131,891	137,894	142,434	147,026
Shareholders funds (incl. minorities)	440,190	413,236	420,297	432,994	452,073	479,034	513,697	556,318
Net (debt)/ cash	(288,969)	(342,050)	(319,684)	(302,972)	(285,371)	(262,614)	(230,336)	(187,656)
Free cash flow (Rs mn)								
EBITDA	71,852	84,042	74,295	84,125	95,437	105,734	115,737	125,622
Change in working capital	(7,642)	(35,330)	(22,324)	(2,607)	(4,455)	(3,736)	(4,512)	(3,959)
Cash tax (paid)	(3,725)	(118)	(372)	(810)	(1,659)	(2,996)	(4,727)	(6,938)
Capex on PP&E and intangibles	(41,621)	(128,441)	(11,271)	(45,315)	(52,431)	(58,303)	(58,102)	(58,377)
Free cash flow	29,422	(93,350)	19,526	14,199	15,558	21,154	31,124	41,677
Ratios (%)								
EBITDA margin	33.4	37.5	33.2	33.7	34.7	35.5	36.3	37.1
RoAE	11.0	3.2	1.3	2.7	4.1	5.6	6.9	7.9
ROAE (excl. cash and int. income)	9.6	1.6	0.8	2.3	3.9	5.6	6.9	8.0
RoACE	5.0	4.0	3.5	4.4	5.4	6.4	7.4	8.4
ROACE (excl. cash and int. income)	4.2	3.0	3.4	4.3	5.4	6.4	7.4	8.5
Net debt/EBITDA (X)	4.0	4.1	4.3	3.6	3.0	2.5	2.0	1.5
Net debt/equity (X)	0.7	0.8	0.8	0.7	0.6	0.5	0.4	0.3

Source: Company, Kotak Institutional Equities estimates

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Source: Kotak Institutional Equities

As of June 30, 2011

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