Reliance Communications – REDUCE

RCOM IN	Rs164	Telecom	05 March 2010	Company update

The search for momentum

RCOM's GSM traffic / site is at sub-optimal levels and rural net adds lag peers significantly. CDMA 3G data cards (~1.5m subs currently) business will face a threat with 3G auctions finally happening, almost assuredly. A 3G DCF model for RCOM (@ US$1.5bn spectrum cost) throws up a large negative NPV and moreover, RCOM will need to pay 1% incremental spectrum fees even if it doesn't win 3G. The spectrum charge and recent 8% diesel price hikes causes EPS cut for FY11 and FY12 by 8% and 5% respectively. For now we maintain REDUCE, and with a marginally reduced DCF TP of Rs140.

Data cards the only strong wireless play, but threatened by 3G: RCOM's revenue market share slipped in 3Q by 100bps to 14.7%, despite extreme aggressiveness on tariffs. We believe that GSM traffic per site needs to go up at least 2x to attain modest profitability. RCOM's rural adds lag peers by a significant margin, as per TRAI data. The CDMA 3G data cards business (~1.5m subs currently) holds more promise—globally, wireless broadband traffic grew 158% YoY. However, 3G auctions (finally) may blunt this edge.

Tough for RCOM to make money from 3G spectrum; BWA more likely: A DCF model for RCOM focused on 3G (@ US$1.5bn spectrum cost) throws up a large negative NPV, despite aggressive assumptions on data %. It confirms that RCOM lacks the GSM subscriber base to exploit handset-based wireless broadband opportunities (data cards already serviced by CDMA EVDO). However, RCOM will need to pay 1% incremental spectrum fees even if it doesn't win 3G. We model US$400m for pan-India 3G+Wimax.

Maintain REDUCE (TP Rs140): The spectrum charge and recent 8% diesel price hikes (but not MAT hike) causes EPS cut for FY11 and FY12 by 8% and 5% respectively. For now we maintain REDUCE, and with a marginally reduced TP of Rs140, based on 12% WACC and TGR of cash flow of 4%. In our FY10 P&L, Rs15.7bn of gains are included from US$/INR movements to date, which exaggerates the EPS drop in FY11.

Global data traffic growth has been phenomenal – can RCOM exploit similar trends in India?

Mobile broadband connections	End 2008	End 2009
# devices including mobiles and USB dongles (m)	189	312
Traffic (MB per month)	175	273
Traffic growth (y-o-y)		158%

Source: Economist, IIFL Research

Financial Summary

Y/e 31 Mar	FY08A	FY09A	FY10ii	FY11ii	FY12ii
Revenues (Rs m)	188,274	222,505	219,101	214,393	239,175
EBITDA Margins (%)	42.3	38.7	33.3	29.3	31.4
Pre-Exceptional PAT (Rs m)	54,023	60,449	42,758	19,092	26,226
Reported PAT (Rs m)	54,023	60,449	42,758	19,092	26,226
EPS (Rs)	26.2	29.3	20.7	9.2	12.7
Growth (%)	69.1	11.9	-29.3	-55.3	37.4
PER (x)	6.3	5.6	7.9	17.7	12.9
ROE (%)	20.8	17.0	9.6	4.0	5.3
Debt/Equity (x)	0.5	0.7	0.6	0.6	0.5
EV/EBITDA (x)	6.0	7.2	8.5	9.9	8.2
Price/Book (x)	1.2	0.8	0.7	0.7	0.7

Price as at close of business on 04 March 2010

12-mth TP	***(Rs) 140 (-15%)***
Market cap (US$ m)	**7,401**
52Wk High/Low (Rs)	362/131
Diluted o/s shares (m)	2064
Daily volume (US$ m)	22
Dividend yield FY10ii (%)	0.6
Free float (%)	32.5

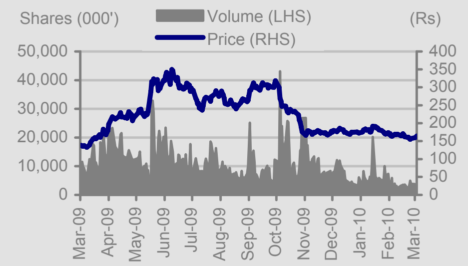
Shareholding pattern (%)

Promoters	67.5
FIIs	7.6
Domestic MFs	9.7
Others	15.2

Price performance (%)

	1M	3M	1Y
RCOM	-0.3	-8.3	20.0
Rel. to Sensex	-4.9	-7.6	-81.0
Bharti Airtel	-3.5	-5.3	-2.2
Idea	4.6	12.2	33.7
MTNL	3.1	-1.0	16.7

Stock movement



G V Giri
gvgiri@iiflcap.com
91 22 4646 4676

Wireless struggling for momentum

In 3QFY10, as per TRAI's data, modified by including revenues not reported by RCOM to TRAI, but reported under the wireless division to the stock exchanges, RCOM's revenue market share slipped marginally in 3QFY10.

Figure 1: Gap between TRAI and Exchanges revenue Rs8bn per quarter

Rs m	1QFY10	2QFY10	3QFY10
RCOM Revenue	47,931	40,100	40,225
Revenue in TRAI	30,492	31,634	32,179
Differential	17,439	8,466	8,046

Source: Company, TRAI, IIFL Research

Figure 2: Including this RCOM's revenue market share slipped marginally in 3Q

% Revenue Mkt Share	1QFY10	2QFY10	3QFY10
Bharti	31.7%	32.4%	31.3%
Vodafone	19.5%	19.8%	20.2%
RCOM	17.0%	14.8%	14.7%
Idea	11.4%	11.4%	12.3%
BSNL + MTNL	9.5%	9.9%	9.4%
Tata Tele + TD	6.6%	7.2%	7.2%
Others	4.3%	4.5%	4.9%
Total	100.0%	100.0%	100.0%

Source: Company, TRAI, IIFL Research. RCOM's market share loss in 2Q relative to 1Q was largely explained by the company as relating to discontinuation of handset revenues.

Figure 3: RCOM's has sub-optimal traffic (minutes) / BTS as of 3Q

Company	BTS count	MOU (qtrly)	MOU/BTS
Bharti	102,190	153,241	499,856
Vodafone	91,402	83172	303,319
Idea	55,804	57,841	345,501
Spice	7,146	6,317	294,664
RCOM (GSM, estimated)	52,000	18,620	119,357
RCOM (CDMA, estimated)	27,000	65,905	813,640
BSNL	37,000	110,063	991,557

Source: Companies, IIFL Research. Data principally taken from 3QFY10; GSM minutes calculated at an estimated ARPU of Rs75, using a rate of Rs0.47/min

What figure 3 tells us that RCOM's GSM has some way to go before catching up with even Spice Comm. While one may argue that RCOM's GSM is layered over CDMA, the fact that almost 50% of the towers are only from GSM, and hence of one theoretically were to apportion GSM minutes only over these pure GSM towers, even then the MOU / BTS on GSM would fall short of Spice.

Still higher up the order is Idea Cellular, at 345,000 min / BTS, from which it generates a blended EBITDA margin of 23% (excluding Spice). Hence unless RCOM has a significantly better cost structure driven by traffic per site, GSM will be a drag on profits for some time to come. For reaching Idea's levels of traffic per site, RCOM will need additional 2G spectrum.

Rural thrust lags compared to peers

RCOM's subscriber base is likely to have a significant composition of double SIMs. This we estimate on the following basis:

Figure 4: RCOM's rural adds not impressive; urban adds are largely multi-SIM

Company	2Q Rural adds	% share
Bharti	4.67	29.5%
Reliance	1.16	7.3%
Vodafone	2.46	15.5%
BSNL	1.57	9.9%
Idea	2.35	14.8%
Tata	1.5	9.5%
Aircel	1.92	12.1%
HFCL	0	0.0%
Shyam	0.2	1.3%
Total	15.83	100.0%

Source: TRAI KPI report, IIFL Research

Note that rural subscriber count depends on the definition of rural, and TRAI's numbers above are based on a classification different from RCOM's own classification. As per your discussion with the company, the rural proportion based on RCOM's own classification would be higher. Nevertheless, based on TRAI count as in Fig 4 above, it is clear that of the 7.7m subscribers added by RCOM in 3Q, only 1.16 came from rural markets, which is 15% of the total adds. For Bharti this proportion is close to 60%.

Strategically the lack of clear focus on rural expansion is likely to cost the company as far as revenue growth is concerned because in urban areas, despite a population of only 310m (including people outside the 15-74 actively consuming age group), the subscriber count as of Dec-09 was almost 358m, and it is from this already saturated market that RCOM is drawing most of its adds.

We believe that significant revenue growth (>5ppt addition to revenue CAGR) can come from rural areas as that market opens up. Currently the revenue growth for the industry from rural areas is being masked by revenue shrinkage in urban areas, where tariffs fall has not been compensated by subscriber + usage growth due to flagging elasticity.

Data cards – the big hope...

In Fig 1, the differential between TRAI revenues and stock exchange revenues of Rs8.04bn in 3Q includes Rural Digital Exchange Lines (RDEL), data cards (2G and 3G) and non-P2P SMS + other VAS.

We estimate that RCOM has ~1.5m subscribers and is likely to touch 2m by FY11. RCOM's data cards are running on EVDO on 850MHz, and competing products are from Tata Teleservices (Photon), Virgin Mobile (now on CDMA 3G also in alliance with Tatas), Sistema and BSNL, all on CDMA EVDO. While anecdotal evidence of user experience has been good, in our opinion, the pace of addition has been slow.

Potential industry market cap could be US$7bn-8bn conservatively: Potentially, this is a market of significant size – we estimate that there can be 20m data card consumers in India, very conservatively.

Figure 5: Global data traffic growth has been phenomenal

Mobile broadband connections	End 2008	End 2009
# devices including mobiles and USB dongles (m)	189	312
Traffic (MB per month)	175	273
Traffic growth (y-o-y)		158%

Source: Economist, IIFL Research

In India, data card ARPUs are estimated to be in the region of Rs800 p.m. The EBITDA margin on these cards will be higher than the typical industry wireless (steady state) EBITDA margins of 30% by the extent of interconnect charges, i.e. they could be ~40%-45% (higher for RCOM since RCOM does not include this in the TRAI revenues on which license fees are paid). As the market expands the ARPU will drop to levels of Rs600 per month (we expect that the rate of data traffic growth will strain spectrum and provide support for pricing).

At an EV/EBITDA of 6x, this could amount to ~US$7bn-8bn in market cap (=20m subscribers * Rs.600 * 12 months * 40% Ebitda margin * 6x EV/EBITDA / US$-INR of Rs46). If RCOM, which has a lion's share of this market currently, is able to maintain its lead, it could amount to a very significant fraction of its market cap.

Expect more capacity for CDMA 3G data cards: Keeping this in mind, we would expect RCOM to take advantage of improvements in CDMA technology which are continually happening and squeeze voice traffic into 2 carriers from the current 3, and liberate 1 carrier for EVDO data cards business, in addition to the 1 carrier already devoted to this (each carrier is 2x1.25MHz).

However, in this context, the announcement of the 3G auctions is a definite negative for RCOM – it burdens RCOM's GSM voice business with the task of additional returns if 3G spectrum is won, or the possibility of widening of the RPM differential between RCOM and listed peers if 3G spectrum is not won, which RCOM will likely try to bridge with EVDO and Wimax. For 3Q RCOM's RPM was Rs0.45/min which is 13.5% lower than those of Bharti / Idea.

GSM 3G doesn't make sense for RCOM:

Note that GSM 3G is based on the more spectrally efficient CDMA technology, and spectrum will be awarded in blocks of 2x5MHz. Hence the capacity per MHz will roughly be 2x the capacity of GSM, and we have seen that RCOM already has a sub optimal cost structure (based on traffic per tower), and the company will have little incentive to increase spectrum at hand by aggressively bidding for 3G GSM spectrum. Rather, we would imagine that a better strategy is to steadily build momentum around GSM, and bundle CDMA EVDO + Wimax services as differentiators and then aim for 4G.

Figure 6: 3G spectrum on pan-India basis would cost ~ US$1.5bn by our estimates

Assumptions	Value	Comments
3G Capex (Rs m, spread over 3 yrs)	20,700	Assuming 15,000 BTSs for 3G within 3 years
Steady State EBITDA on 3G	40%	We expect products to have sufficient differentiation to command premium pricing and margins, given that only 4 operators will offer 3G
Capex to Sales (steady state)	12%	
Terminal Growth Rt of Cash Flow	4%	
Weighted Avg Cost of Capital WACC	12%	
3G spectrum auction price	-69,000	Based on a clearing price of US$1.5bn, a bit higher than our previous estimates since now there are only 3 slots relative to 4 as per earlier announcements

Source: IIFL Research

Figure 7: At this price, difficult to see how RCOM can make money from 3G

DCF MODEL	Y0 - 3/2010	Y1	Y2	Y3	Y7 – terminal year of DCF model
Revenue growth assumed		10%	9%	8%	8%
GSM Revenue (Rs m, based on 40m subs @ Rs75 ARPU)	36,000	39,600	43,164	46,617	63,422
Data % of revenue	9%	12%	15%	18%	28%
Data Revenue (Rs m)	3,240	4,752	6,475	8,391	17,758
Incremental Data Rev attributable to 3G- i.e. excess over9% (Rs m)		1,188	2,590	4,196	12,050
EBITDA %		-100%	-	30%	40%
EBITDA (Rs m)		-1,188		1,259	4,820
Capex (Rs m)	-6,900	-6,900	-6,900	-503	-1,446
Depreciation (Rs m)		1,380	1,863	1,696	1,794
Amortization of spectrum @ 5% (Rs m)		3,450	3,450	3,450	3,450
EBIT (Rs m)		-6,018	-5,313	-3,888	-423
Tax Rate		10.0%	11.0%	12.0%	16.0%
WC Δ		-49	-164	-184	-146
Free Cash Flow to Firm FCFF (Rs m)	-75,900	-7,535	-6,480	1,038	3,296
NPV (Rs m)	-64,959				

Source: IIFL Research

3G however will raise spectrum cost willy-nilly: The WPC (wireless planning and co-ordination committee) has stipulated increased spectrum charges for GSM and CDMA, regardless of whether 3G spectrum is won or not. This contrasts with the earlier proposed structure, which is also featuring in the notice inviting applications for 3G, that 3G winners will pay an incremental 1%. The new schedule of charges seems to have been primarily motivated by 3G, however.

Figure 8: Government has raised all spectrum charges by 1% w.e.f. 1st April 2010

Spectrum charges		Spectrum charges % AGR
GSM	**CDMA**	
Up to 2 x 4.4 MHz	Up to 2 x 5.0MHz	3
Upto2 x 6.2MHz	Up to 2 x 6.25MHz	4
Upto2 x 8.2MHz	Up to 2 x 7.5MHz	5
Upto2 x 10.2MHz	Up to 2 x 10.0MHz	6
Upto2 x 12.2MHz	Up to 2 x 12.5MHz	7
Upto2 x 15.2MHz	Up to 2 x 15.0MHz	8

Source: WPC (DoT), IIFL Research

RCOM currently pays 2% spectrum charges on both GSM and CDMA, and this will get raised to 3%, even if RCOM doesn't win 3G.

Will this affect Bharti and Idea – perhaps not: There is a reasonable chance that keeping in mind possible 3G spectrum wins, Wimax and possible release of spectrum in the 700MHz band in the medium term, Bharti returns some of its spectrum by FY12 overall spectrum charges unchanged. Idea would probably be able to save 30-40bps this way, and RCOM unable to avoid this increase. In FY11, however, all will likely pay the excess charges.

Wimax a better option for RCOM: We believe that RCOM will bid aggressively for Wimax spectrum, as it is likely to be significantly cheaper than 3G, as well as being possibly reusable for 4G in the long term. We estimate that Wimax spectrum will fetch a little over 1/4th the price of 3G, i.e. US$400m for pan-India spectrum, which also happens to be 5% more than the reserve price.

We expect RCOM to bid for 3G for strategic reasons, and in our model, build, US$400m for 3G+Wimax and raise spectrum charges by 1% of wireless revenues.

Diesel cost increase will impact EBITDA % by 25bps: In the recent budget presented in February, the government raised diesel prices by ~8%. We believe diesel is the primary energy source in rural areas, and accounts for 50% of energy costs of ~Rs20,000/month/tower/tenant for most operators, and is a higher % in rural areas. For RCOM, the rural exposure is relatively lower, but on CDMA, the energy costs per tower are significantly higher than in GSM, and the two effects almost cancel out. Hence for RCOM, too, we assume Rs10,000/tower/month as the spend on diesel.

Hence we believe the EBITDA hit for RCOM would be Rs10,000/tower/month * 52,000 towers (estimated) * 3 months * 0.08 = ~25bps impact on EBITDA margin.

Hence in conclusion, we summarize our assessment of RCOM's business as follows:

- GSM traffic levels are sub-optimal and need to go up at least 2x to reach levels of modest profitability.
- Lack of rural focus relative to competition (as per TRAI data) will suppress long term revenue growth for RCOM.
- CDMA data cards are a very strong product, since it is on the 850MHz spectrum of which RCOM has 5MHz on a pan-India basis. While currently RCOM devotes only 25% of this CDMA spectrum to data cards, we expect it to increase the allocation to 50% over the next year, to take advantage of what can be a very large opportunity in terms of contribution to market cap. Globally, data traffic on wireless broadband grew by 158% y-o-y, and before long this will be a feature of Indian telecom also, and RCOM's data cards business will likely ride on this.
- However, with 3G auctions happening, almost assuredly, beginning April 2010, RCOM's lead time with this product will be curbed, and competition will force the market to be sliced up into more slices, as well as ARPU down from current estimated levels of Rs800 down by perhaps 25%. Hence rather than build in strong incremental upsides from data cards we would watch for evidence that RCOM's execution holds up against competition.
- 3G spectrum does not make sense for RCOM as it lacks the subscriber base to exploit handset based wireless broadband opportunities. Data cards are already being serviced by CDMA EVDO, plus BWA (using Wimax) may serve the purpose equally well. However, RCOM need to cough up 1% incremental spectrum fees as the charges have been increased by 1ppt (% of AGR) across the board, because of 3G, but regardless of whether operators win 3G spectrum or not.
- Wimax makes better sense for RCOM because the BWA spectrum on offer in 2.3GHz may be re-usable in the long run for 4G, besides likely being cheaper than 3G. We estimate that RCOM will need to bid US$400m, 5% more than the reserve price. This relatively tame premium to reserve price is because 2.3GHz is not the best spectrum for Wimax today (the better spectrum in 2.5GHz is given to BSNL and MTNL). We model US$400m as the total of 3G + Wimax spectrum in the auctions.
- The recent diesel price hike will impact EBITDA margins by 0.25%.

The spectrum charges and diesel price increase causes us to cut EPS for FY11 and FY12 by 8% and 5%.

While we feel that in the long run, the value of the 850MHz spectrum held on a pan-India basis will become crucial to valuation as a separate element in itself, in the medium term, RCOM must move more rapidly than it has been able to in the last few quarters to generate revenue growth momentum from any business. For now we maintain REDUCE, and with a marginally reduced TP of Rs140, based on 12% WACC and TGR of cash flow of 4%. In our FY10 P&L, Rs15.7bn of gains are included from US$/INR movements to date, which exaggerates the EPS drop in FY11.

Financial summary

Income statement summary (Rs m)

Y/e 31 Mar	FY08A	FY09A	FY10ii	FY11ii	FY12ii
Revenue	188,274	222,505	219,101	214,393	239,175
EBITDA	79,585	86,070	72,967	62,723	75,033
EBIT	**51,540**	**39,762**	**38,865**	**29,845**	**40,239**
Interest income	0	15,780	7,723	6,926	8,126
Interest expense	3,998	-10,711	-5,181	-18,294	-18,744
Exceptional items	12,829	0	0	0	0
Others items	2,404	17,136	6,207	4,000	2,000
Profit before tax	**70,770**	**61,967**	**47,614**	**22,477**	**31,621**
Tax expense	-2,836	518	-2,038	-1,124	-2,213
Extraordinary items	-13,911	-2,036	-2,818	-2,261	-3,181
Net Profit	**54,023**	**60,449**	**42,758**	**19,092**	**26,226**

Cashflow summary (Rs m)

Y/e 31 Mar	FY08A	FY09A	FY10ii	FY11ii	FY12ii
Profit before tax	70,770	61,967	47,614	22,477	31,621
Depreciation & Amortization	28,045	46,308	34,101	32,878	34,794
Tax paid	-2,160	518	-2,038	-1,124	-2,213
Working capital change	1,380	-33,241	-30,815	-6,576	-5,356
Other operating items	-9,770	0	0	0	0
Operating Cash-flow	**88,266**	**75,553**	**48,862**	**47,656**	**58,845**
Capital expenditure	-229,815	-194,168	-44,733	-54,291	-15,513
Free cash flow	**-141,549**	**-118,615**	**4,129**	**-6,636**	**43,332**
Equity raised	8,794	0	0	0	0
Investments	-32,882	14,339	83,855	0	0
Debt financing/disposal	96,390	133,405	-6,071	-5,000	-15,000
Dividends paid	-1,183	-1,932	-1,932	-1,932	-1,932
Other items	7,204	-19,149	-2,818	-2,261	-3,181
Net change in Cash & cash equivalents	**-63,226**	**8,049**	**77,163**	**-15,829**	**23,219**

Source: Company data, IIFL Research

Balance sheet summary (Rs m)

Y/e 31 Mar	FY08A	FY09A	FY10ii	FY11ii	FY12ii
Cash & cash equivalents	118,776	112,486	105,795	89,966	113,185
Sundry debtors	27,224	39,618	44,617	43,658	48,705
Trade Inventories	4,059	5,427	3,759	3,463	3,864
Other current assets	23,059	17,714	16,374	16,474	16,574
Fixed assets	**523,125**	**727,053**	**737,685**	**739,898**	**739,817**
Intangible assets	35,654	52,215	52,215	71,415	52,215
Other assets	42,695	67,557	59,695	64,695	69,695
Total assets	**774,593**	**1,022,069**	**1,020,139**	**1,029,570**	**1,044,055**
Sundry creditors	86,341	51,168	16,027	17,261	12,498
Other current liabilities	114,435	149,646	148,101	144,138	154,091
Long-term debt/Convertibles	258,217	391,622	385,551	380,551	365,551
Other long-term liabilities	1,028	281	281	281	281
Minorities/other Equity	24,309	6,549	6,549	6,549	6,549
Net worth	**290,263**	**422,803**	**463,630**	**480,790**	**505,085**
Total liabilities & equity	**774,593**	**1,022,069**	**1,020,139**	**1,029,570**	**1,044,055**

Ratio Analysis

Y/e 31 Mar	FY08A	FY09A	FY10ii	FY11ii	FY12ii
Revenue growth (%)	30.7	18.2	-1.5	-2.1	11.6
Op Ebitda growth (%)	40.7	8.1	-15.2	-14.0	19.6
Op Ebit growth (%)	61.5	-22.9	-2.3	-23.2	34.8
Op Ebitda margin (%)	42.3	38.7	33.3	29.3	31.4
Op Ebit margin (%)	27.4	17.9	17.7	13.9	16.8
Net profit margin (%)	28.7	27.2	19.5	8.9	11.0
Dividend payout (%)	5.7	2.7	3.9	8.6	6.3
Tax rate (%)	4.0	-0.8	4.3	5.0	7.0
Net debt/equity (%)	48.0	66.0	60.3	60.4	50.0
Net debt/op Ebitda (x)	1.8	3.2	3.8	4.6	3.4
Return on equity (%)	20.8	17.0	9.6	4.0	5.3
ROCE (%)	7.3	5.0	3.8	2.7	3.6
Return on assets (%)	5.9	4.3	3.4	2.5	3.2

Source: Company data, IIFL Research

Key to our recommendation structure

BUY - Absolute - Stock expected to give a positive return of over 20% over a 1-year horizon.
SELL - Absolute - Stock expected to fall by more than 10% over a 1-year horizon.

In addition, **Add** and **Reduce** recommendations are based on expected returns relative to a hurdle rate. Investment horizon for **Add** and **Reduce** recommendations is up to a year. We assume the current hurdle rate at 10%, this being the average return on a debt instrument available for investment.

Add - Stock expected to give a return of 0-10% over the hurdle rate, ie a positive return of 10%+.
Reduce - Stock expected to return less than the hurdle rate, ie return of less than 10%.
