

Reliance Communication

STOCK INFO.	BLOOMBERG
BSE SENSEX: 14,516	RCOM IN
	REUTERS CODE
S&P CNX: 4,215	RLCM.BO

5 February 2007

Buy

Previous Recommendation: Buy

Rs515

Equity Shares (m)	2,044.6
52-Week Range (Rs)	518/186
1,6,12 Rel. Perf. (%)	10/58/-
M.Cap. (Rs b)	1,053.2
M.Cap. (US\$ b)	23.9

YEAR	NET SALES	PAT	EPS	EPS	P/E	P/BV	ROE	ROCE	EV/	EV/
END	(RS M)	(RS M)	(RS)	GROWTH (%)	(X)	(X)	(%)	(%)	SALES	EBITDA
3/06A	107,664	4,439	2.2	NA	237.3	9.0	7.6	7.4	10.0	43.6
3/07E	146,724	30,172	14.8	579.7	34.9	7.1	22.7	13.6	7.4	18.7
3/08E	207,533	45,678	22.6	53.0	22.8	5.4	26.7	18.9	5.1	12.4

- Reliance Communication (RCOM) posted better than expected PAT for 3QFY07. However, operating performance was in-line. Revenues grew 6.5% QoQ to Rs37.5b (v/s our estimate of Rs38.9b) while PAT was up 31.6% QoQ to Rs9.2b (v/s our estimate of Rs6.8b).
- Wireless revenue grew just 6.9% QoQ (v/s 13.8% for Bharti), indicating wireless ARPU decline of 7.2%. Wireless margins expanded by 130bp QoQ to 37.4% (v/s our estimate of 36.3%). Broadband revenue grew 16.6% QoQ (v/s our estimate 21.6%); margins expanded 220bp QoQ to 47%. Global business revenue grew 1.3% QoQ (v/s our estimate 6%); margins expanded 230bp QoQ to 26.6% (v/s our assumption of flat margins).
- Despite lower than expected revenue growth, strong margin expansion across segments has resulted in EBITDA of Rs15.3b (v/s our estimate of Rs15b). Although consolidated EBITDA is in-line with our estimates, PAT is significantly higher than our estimate at Rs9.2b – RCOM reported a net finance income of Rs657m v/s our estimate of net finance cost of Rs1b.
- Due to higher than expected margins across business segments, our EPS estimates for FY07, FY08 and FY09 are revised upwards by 12.5%, 8.5%, and 3.5%, respectively. The stock trades at 22.8x FY08E and 17.8x FY09E earnings. We maintain **Buy**.

QUARTERLY PERFORMANCE (CONSOLIDATED)

(RS MILLION)

Y/E MARCH	FY06				FY07				FY06	FY07E
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4QE		
Gross Revenue	22,830	25,220	29,910	29,704	32,501	35,260	37,553	41,411	107,664	146,724
YoY Growth (%)					42.4	39.8	25.6	39.4	34.5	36.3
QoQ Growth (%)		10.5	18.6	-0.7	9.4	8.5	6.5	10.3		
Total Operating Expenses	21,240	20,950	21,430	19,282	20,439	21,734	22,281	24,509	82,902	88,964
EBITDA	1,590	4,270	8,480	10,422	12,062	13,525	15,272	16,902	24,762	57,761
Margin (%)	7.0	16.9	28.4	35.1	37.1	38.4	40.7	40.8	23.0	39.4
Net Finance Costs	270	650	1,280	425	999	56	-657	450	2,625	2,502
Cash Profit from Operations	1,320	3,620	7,200	9,997	11,063	7,288	15,929	16,452	22,137	50,732
Depreciation & Amortisation	3,760	3,790	3,980	5,457	5,514	6,237	6,524	7,342	16,987	25,618
Profit before Tax	-2,440	-170	3,220	4,540	5,549	7,233	9,404	9,110	5,150	31,295
Income Tax Expense / (Income)	60	20	120	137	272	59	130	182	337	644
Net Profit / (Loss)	-2,500	-190	3,100	4,029	5,127	7,023	9,244	8,777	4,439	30,172
QoQ Growth (%)		-92.4	-1731.6	30.0	27.3	37.0	31.6	-5.0		
Margin (%)		-0.8	10.4	13.6	15.8	19.9	24.6	21.2	4.1	20.6

E: MOST Estimates

Wireless business: steep ARPU decline

Despite 15.4% QoQ subscriber growth (v/s 17.2% QoQ for Bharti), RCOM's wireless revenues grew 6.9% QoQ (v/s 13.8% QoQ for Bharti). Its wireless ARPU declined 7.2% QoQ (v/s 2.5% QoQ decline for Bharti) from Rs354 to Rs328. (Bharti's ARPU was Rs427 in 3QFY07). The management attributed the decline in MoU and ARPU to tariff rationalization and free bundling of minutes. Prepaid customers comprised over 92% of the new wireless customer additions in 3QFY07. Wireless margins expanded from 36.1% in 2QFY07 to 37.4% in 3QFY07 due to flat EBITDA per minute and higher growth in net revenue. RCOM's monthly subscriber churn declined to 1.8% from 1.9% in 2QFY07. Non-voice revenues were stagnant.

WIRELESS BUSINESS PERFORMANCE

	Q4FY06	Q1FY07	Q2FY07	Q3FY07	QOQ GR.
Revenue	21,200	24,320	25,744	27,520	6.9
Net Revenue	12,645	16,544	17,998	19,308	7.3
Net Rev. as % of Total Rev.	59.6	68	69.9	70.2	
EBITDA	7,571	8,746	9,294	10,290	10.7
EBITDA Margins (%)	35.7	36.0	36.10	37.4	
EBIT	3,998	5,144	5,131	5,542	8.0
EBIT Margins (%)	18.9	21.2	19.9	20.1	
Susbscribers	20.2	22.5	26.0	30.0	15.4
RPM	0.7	0.8	0.8	0.7	-6.5
MOU	532	491	461	454	-1.5
ARPU	379	379	354	328	-7.3
EBITDA per Minute	0.3	0.3	0.3	0.3	-3.5
Cumulative Minutes	29.7	31.4	33.5	38.1	13.7

Source: Company/ Motilal Oswal Securities

Global business: significant margin expansion

While gross revenue grew by just 1.3% QoQ, EBITDA margins expanded by 2.3 percentage points, largely due to higher contribution by data business. Global business margins have expanded from 24.3% in 2QFY07 to 26.6% in 3QFY07 (v/s our estimate of flat QoQ margins.)

Though revenue growth was muted, global business contributed highest at the EBIT level, indicating fixed cost nature of the business. The management indicated that Flag would independently finance the US\$1.5b capex announced

for NGN network through presales of capacity. The Board has approved a global listing of Flag Telecom.

RCOM's India Call subscriber base expanded from 0.8m to 1m, as the company extended the product to newer geographies. Usage of Reliance India Call accounts for around 40% of the total retail market calls from the United States to India.

RCOM's NLD minutes grew by a healthy 8.6% QoQ; its volume growth has lagged VSNL in the ILD segment. RCOM's ILD minutes grew 8.2% QoQ v/s 21.4% QoQ growth in VSNL's ILD volumes. Although Bharti's ILD volume growth was higher at 20% QoQ, it was on much lower base. We expect robust growth in NLD to continue for integrated players.

GLOBAL BUSINESS PERFORMANCE

	Q4FY06	Q1FY07	Q2FY07	Q3FY07	QOQ GR.
Revenue	14,158	12,340	13,158	13,335	1.3
Net Revenue	7,184	7,174	7,283	7,202	-1.1
Net Rev. as % of Total Rev.	50.7	58.1	55.4	54.0	
EBITDA	2,632	2,842	3,199	3,550	11.0
EBITDA Margin (%)	18.6	23.0	24.3	26.6	
EBIT	1,355	1,554	1,785	2,491	39.5
EBIT Margin (%)	9.6	12.6	13.6	18.7	

Source: Company/ Motilal Oswal Securities

Broadband: robust growth in access lines

While broadband ARPU declined by 8.8% QoQ, both EBITDA and EBIT margins have shown robust improvement, with 24.7% QoQ growth in access lines. With international bandwidth now becoming available on FALCON and Flag Europe-Asia cable systems, RCOM is likely to re-launch its international product portfolio for enterprises in India. RCOM has completed trials of IPTV services in more than 10,000 premises and has received positive response from trials. RCOM expects to launch its IPTV as well as DTH services in 3Q FY08. While we remain bullish on the DTH opportunity, we would like to see concrete steps related to content tie-ups to incorporate the opportunity in our model. We believe that the broadband business margins will continue to remain robust.

BROADBAND BUSINESS PERFORMANCE

	Q4FY06	Q1FY07	Q2FY07	Q3FY07QOQ	GR. (%)
Revenue	1,948	2,271	2,710	3,161	16.6
Net Revenue	1,685	1,872	2,331	2755	18.2
EBITDA	606	882	1,215	1486	22.3
EBITDA Margins (%)	31.1	38.8	44.8	47.0	
EBIT	242	518	851	1090.5	28.1
EBIT Margins (%)	12.4	22.8	31.4	34.5	
Access lines '000	256	322	425	530	24.7
Net additions '000	39	66	103	105	1.9
ARPL Rs/line	2742	2618	2420	2206	-8.8

Source: Company/ Motilal Oswal Securities

FY08 capex guidance of US\$2.5b up 42% from FY07

Total capex in 3QFY07 was US\$351m; in 1HFY07 capex was US\$785m. Most of the capex was financed by operational cash flow and decrease in working capital. Management has upped its capex guidance for FY07 from US\$1.4-1.5b to US\$1.75 b. Management has guided for capex of US\$2.5b (excluding Flag NGN project capex of US\$1.5b in the next three years). We maintain our current capex estimate of US\$1.9b for FY07 and US\$1.8b for FY08 till we get further clarity on GSM and other emerging opportunities such as DTH and IPTV. However, we believe the higher capex guidance is a positive indication. RCOM's gross debt was US\$2.5b as at end-3QFY07. Adjusting for cash of US\$2.3b, the net debt figure was about US\$328m, against US\$457m in 2QFY07.

Operating performance in-line; PAT above estimate due to forex gain

RCOM's 3QFY07 reported PAT was above our expectations. However, operating performance is in line. Revenues are up 6.5% QoQ to Rs37.5b (v/s our estimate of Rs38.9b) while PAT is up 31.6% QoQ to Rs9.24b (v/s our estimate of Rs6.87b). Despite lower than expected revenue growth, strong margin expansion across segments has resulted in EBITDA of Rs15.27b (v/s our estimate of Rs15b). EBITDA margins expanded 230bp QoQ to 40.7% as both network operating costs as well as employee cost declined by 3.8% and 3.1%, respectively on QoQ basis.

Although consolidated EBITDA is in-line with our estimates, PAT is significantly higher than our estimate at Rs9.24b, as RCOM reported a net finance income of Rs657m v/s our estimate of net finance cost of Rs1b.

Revision in estimates to factor higher segmental margins

We have revised our estimates to reflect higher than expected margins across business segments. However, we have also reduced our revenue estimates to adjust for lower than expected revenue growth in global business and higher than expected contraction in ARPU. We have revised our revenue estimates downward by 1.7%, 3.1% and 3.5% for FY07, FY08 and FY09, respectively. However, due to higher than expected margins across business segments, our EPS estimates for FY07, FY08 and FY09 are revised upwards by 12.5%, 8.5%, and 3.5%, respectively.

ESTIMATES (%)

	FY07	FY08	FY09
Revised			
Wireless EBITDA margins	37.1	37.5	37.8
Broadband EBITDA margins	43.5	44.5	42.5
Global Business EBITDA margins	25.0	26.0	25.0
Earlier			
Wireless EBITDA margins	36.3	36.8	37.5
Broadband EBITDA margins	40.0	39.0	37.0
Global Business EBITDA margins	23.2	23.0	23.0

Source: Company/ Motilal Oswal Securities

Valuation and view

We believe that momentum in wireless business is intact, driven by strong subscriber additions. Broadband business is likely to gain traction, with strong subscriber additions and robust margins. In the long distance segment, although margins are likely to stabilize, volume growth is likely to be robust. Consolidated margins are expected to improve from 21.9% in FY06 to 41% in FY08 and 41.5% in FY09. We expect RCOM to report EPS of Rs22.6 in FY08 and Rs28.9 in FY09. The stock trades at 22.8x FY08E and 17.8x FY09E earnings. We maintain **Buy**.

Reliance Communication: an investment profile

Company description

Reliance Communication (RCOM) is an Anil Dhirubhai Ambani Group (ADAG) company that has business interests in wireless, long distance and broadband. The company has rolled out a CDMA-1x network across the country, spanning 3,881 towns. Its global businesses include NLD, ILD and Flag operations. It has more than 60,000 km of fiber optic network and with the commissioning of its FALCON project has 65,500 km of sub-sea cable capacity.

Key investment arguments

- ✍ Second largest operator in the fast growing Indian cellular market and enjoys scale advantage.
- ✍ leading player in the long distance business and broadband business picking up in FY08.
- ✍ Upfront capex strategy and cumulative investment of US\$7b to start paying off

Key investment risks

- ✍ It has been a price leader due to let entry. Declining ARPM's could lead to lower operating margins.
- ✍ Though improving disclosures are positive, a limited financial history remains
- ✍ Bundling of free minutes for new subscribers to subsidize CDMA handset cost could increase, hurting its operating performance.

COMPARATIVE VALUATIONS

		RCOM	BHARTI	INFOSYS
P/E (x)	FY07E	34.9	35.6	33.6
	FY08E	22.8	24.4	25.9
P/BV (x)	FY07E	7.1	11.1	12.3
	FY08E	5.4	7.6	8.9
EV/Sales (x)	FY07E	7.4	8.3	6.4
	FY08E	5.1	5.6	8.7
EV/EBITDA (x)	FY07E	18.7	20.7	27.2
	FY08E	12.4	13.8	20.3

SHAREHOLDING PATTERN (%)

	DEC.06	SEP.06
Promoter	66.8	66.8
Domestic Inst	6.0	6.4
Foreign	15.9	14.6
Others	11.3	12.2

Recent developments

- ✍ Launches mobile blogging (moblogging) an extension of web blogging
- ✍ Inaugurates Falcon cable.
- ✍ Completes restructuring proposal

Valuation and view

- ✍ Revenue CAGR of 34.4% and earnings CAGR of 136.9% over FY06-09E. Valuations at 22.8x FY08E earnings and 17.8x FY09E earnings are attractive and at a discount to some similar sized peers in other fast growing industries, like Infosys.
- ✍ **Buy** with a target price of Rs578, an upside of 12.2% from current levels.

Sector view

- ✍ We believe handset pricing is becoming more important from the perspective of total cost of ownership rather than tariffs.
- ✍ We expect the wireless subscriber base (inclusive of FWP) in India to touch 329m by FY09 and 383m by FY10, rising from the current subscriber base of 145m.
- ✍ Tariff cuts to be compensated by volume and cut in regulatory levies, resulting in decent margins and RoE.

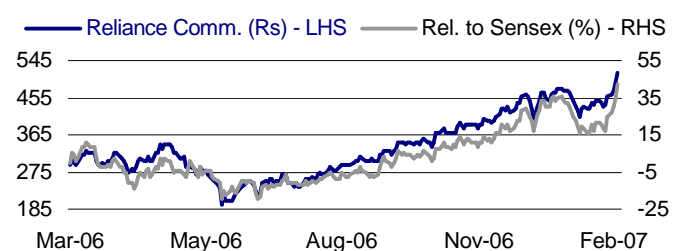
EPS: MOST FORECAST VS CONSENSUS (RS)

	MOST FORECAST	CONSENSUS FORECAST	VARIATION (%)
FY07	14.8	13.3	11.4
FY08	22.6	21.4	5.7

TARGET PRICE AND RECOMMENDATION

CURRENT PRICE (RS)	TARGET PRICE (RS)	UPSIDE (%)	RECO.
515	578	12.2	Buy

STOCK PERFORMANCE (1 YEAR)



INCOME STATEMENT		(Rs Million)			
Y/E MARCH	2006	2007E	2008E	2009E	
Revenues	107,664	146,724	207,533	261,153	
Change (%)	-	36.3	41.4	25.8	
Total Expenses	82,902	88,964	122,376	152,676	
EBITDA	24,762	57,760	85,157	108,477	
% of Gross sales	23.0	39.4	41.0	41.5	
Depn. & Amortisation	16,987	25,618	31,656	37,500	
EBIT	7,775	32,143	53,501	70,976	
Net Interest	-2,625	-848	-749	-674	
PBT	5,150	31,295	52,752	70,302	
Tax	337	644	6,594	11,248	
Rate (%)	6.5	2.1	2.5	16.0	
Adjusted PAT	4,813	30,651	46,158	59,054	
Change (%)		536.8	50.6	27.9	
PAT after EO	4,439	30,172	45,678	59,054	

BALANCE SHEET					
Y/E MARCH	2006	2007E	2008E	2009E	
Share Capital	10,223	10,223	10,223	10,223	
Reserves	107,292	137,943	184,102	233,930	
Net Worth	117,515	148,166	194,325	244,153	
Secured Loans	87,185	107,185	104,185	74,185	
Unsecured Loans	5,791	5,791	5,791	5,791	
Capital Employed	210,491	261,142	304,301	324,129	
Gross Block	230,531	319,231	399,231	498,481	
Less : Depreciation	-47,573	-73,191	-104,846	-142,347	
Net Block	182,958	246,040	294,385	356,134	
CWIP	31,305	30,000	30,000	10,000	
Investments	121	121	121	121	
Curr. Assets	105,355	134,708	162,131	164,667	
Inventories	4,076	4,484	4,932	5,425	
Debtors	16,808	19,329	21,262	23,388	
Cash & Bank Balance	60,038	81,576	103,594	98,603	
Other Current Assets	24,433	29,320	32,343	37,250	
Curr. Liab. & Prov.	109,247	149,727	182,336	206,793	
Sundry Liabilities	89,956	130,436	163,045	187,502	
Other Current Liabilities	19,291	19,291	19,291	19,291	
Net Curr. Assets	-3,892	-15,019	-20,205	-42,126	
Appl. of Funds	210,492	261,142	304,301	324,129	

E: M0St Estimates

RATIOS					
Y/E MARCH	2006	2007E	2008E	2009E	
Basic (Rs)					
EPS	2.2	14.8	22.6	28.9	
Cash EPS	10.5	27.3	37.8	47.2	
Book Value	57.5	72.5	95.0	119.4	
DPS	0.0	0.0	0.0	4.0	
Payout%(Incl.Div.Taxes)	0.0	0.0	0.0	15.6	
Valuation (x)					
P/E	237.3	34.9	22.8	17.8	
Cash P/E	49.2	18.9	13.6	10.9	
EV/EBITDA	43.6	18.7	12.4	9.5	
EV/Sales	10.0	7.4	5.1	3.9	
Price/Book Value	9.0	7.1	5.4	4.3	
Dividend Yield (%)	0.0	0.0	0.0	0.78	
Profitability Ratios (%)					
RoE	7.6	22.7	26.7	26.9	
RoCE	7.4	13.6	18.9	22.6	
Turnover Ratios					
Debtors (Days)	57	48	37	33	
Asset Turnover (x)	0.5	0.5	0.5	0.5	
Leverage Ratio					
Debt/Equity Ratio(x)	0.7	0.7	0.5	0.3	

CASH FLOW STATEMENT		(Rs Million)			
Y/E MARCH	2006	2007E	2008E	2009E	
Op.Profit/(Loss) bef Tax	24,732	57,760	85,157	108,477	
Interest Paid	-2,595	-848	-749	-674	
Direct Taxes Paid	-337	-644	-6,594	-11,248	
(Inc)/Dec in Wkg. Cap.	17,304	32,665	27,204	16,931	
CF from Op.Activity	39,104	88,934	105,018	113,485	
(inc)/Dec in FA +CWIP	-38,581	-87,395	-80,000	-79,250	
(Pur)/Sale of Investments	3,066	0	0	0	
CF from Inv.Activity	-35,515	-87,395	-80,000	-79,250	
Inc/(Dec) in Debt	-12,960	20,000	-3,000	-30,000	
Dividends Paid	0	0	0	-9,225	
CF from Fin.Activity	-12,960	20,000	-3,000	-39,225	
Inc/(Dec) in Cash	-9,371	21,539	22,018	-4,991	
Add: Opening Balance	69,409	60,038	81,576	103,594	
Closing Balance	60,038	81,577	103,594	98,603	



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Disclosure of Interest Statement	Reliance Communication
1. Analyst ownership of the stock	No
2. Group/Directors ownership of the stock	No
3. Broking relationship with company covered	No
4. Investment Banking relationship with company covered	No

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