

Telecom

Target price Rs175

Earnings revision

(%)	FY10E	FY11E
Sales	↓ 16.6	↓ 16.7
EBITDA	↓ 23.7	↓ 21.5
EPS	↓ 20.2	↓ 8.9

Target price revision

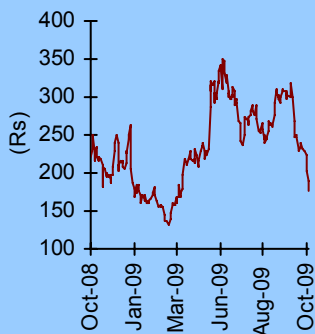
Rs175 from Rs285

Shareholding pattern

	Mar '09	Jun '09	Sep '09
Promoters	67.6	67.8	67.7
Institutional investors	17.3	18.7	19.3
MFs and UTI	2.4	2.0	1.9
Insurance Cos.	7.3	7.3	8.0
FII	7.6	9.4	9.4
Others	15.1	13.5	13.0

Source: NSE

Price chart



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INDIA

Reliance Communications

SELL

Downgrade from HOLD

Rs176

Poor results; more pain to come

Reason for report: Recommendation change & Q2FY10 results review

Reliance Communications (RCom) reported dismal Q2FY10 results in spite of strong subscriber addition, with wireless revenues declining 16.3% QoQ as incremental subscribers are increasingly tending to be free-minute arbitragers. RCom faces steep challenges ahead as it struggles to juggle its business case between two networks by trying to grow voice usage on GSM and data usage on CDMA. We believe that RCom's *Simply Reliance* plan does not have any distinctive competitive advantage as other players have followed with more aggressive plans and pay-per-second plans. We are yet to see the impact of pay-per-second and *Simply Reliance* plans on ARPMs Q3FY10 onwards. As per media, the Department of Telecommunications (DoT)-appointed auditor has raised queries about RCom's accounts that the company has refuted. We downgrade FY10E & FY11E estimates 20.2% and 8.9% respectively. We downgrade RCom to SELL from Hold with revised target price of Rs175/share (earlier Rs285/share), a 15% discount to our DCF-based value of Rs206/share. We await further clarity on RCom's accounts.

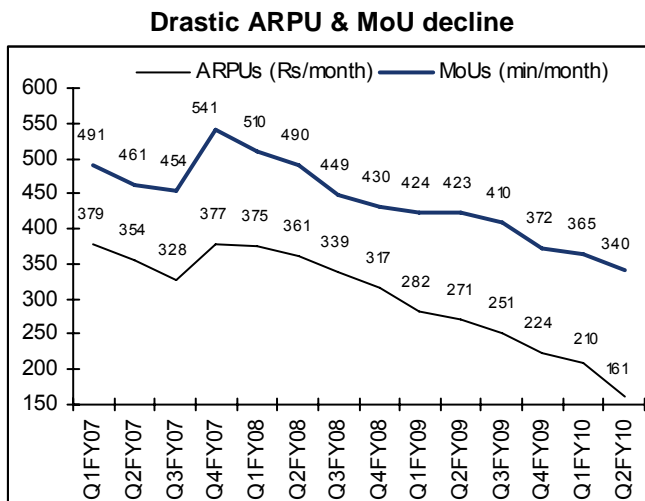
- ▶ **Wireless KPIs topple.** Though all wireless operators witnessed decline in ARPUs in Q2FY10 (Bharti Airtel 9.4% and Idea 9.9%) due to hypercompetition, RCom's decline has been the most drastic, with wireless ARPUs down 23.3% QoQ to Rs161/month, falling below Rs200/month for the first time. MoUs were also down 6.8% QoQ to 340mins/month (I-Sec: Rs361/month) and ARPMs down 18.3% QoQ to Rs0.47/min. The management attributed a part of the decline in wireless revenues to ~Rs8bn reduction in revenues from the sale of CDMA equipment.
- ▶ **Consolidated revenues declined 7.2% QoQ** to Rs57bn (I-Sec: Rs63.9bn) and EBITDA margin contracted 450bps QoQ to 35.4% (I-Sec: 39.6%) on account of 14.9% QoQ rise in network operating expenses owing to expenses on the GSM network coming in fully in the quarter. Reported PAT of Rs7.4bn was down 54.9% QoQ and 53.4% YoY, in spite of lower depreciation and negative taxes.
- ▶ **Earnings revision.** We downgrade FY10E & FY11E estimates 20.2% and 8.9% respectively. Our revised FY10E & FY11E EPS estimates are Rs20.9 and Rs23.9 respectively.
- ▶ **Downgrade to SELL from Hold** with revised target price of Rs175/share from Rs285/share, based on 15% discount to our DCF-based valuation of Rs206/share.

Market Cap	Rs363bn/US\$7.9bn	Year to Mar	2008	2009	2010E	2011E
Reuters/Bloomberg	RLCM.BO/RCOM IN	Revenue (Rs mn)	188,274	222,506	233,864	268,600
Shares Outstanding (mn)	2,064	Net Income (Rs mn)	41,184	60,524	43,204	49,351
52-week Range (Rs)	350/132	EPS (Rs)	20.0	29.3	20.9	23.9
Free Float (%)	32.2	% Chg YoY	12.1	47.0	(28.6)	14.2
FII (%)	9.4	P/E (x)	8.8	6.0	8.4	7.4
Daily Volume (US\$/'000)	37,934	CEPS (Rs)	33.5	46.8	37.2	40.8
Absolute Return 3m (%)	(36.2)	EV/E (x)	8.1	7.5	7.5	6.2
Absolute Return 12m (%)	(20.0)	Dividend Yield (%)	0.4	0.5	-	-
Sensex Return 3m (%)	1.4	RoCE (%)	7.6	7.9	5.7	6.7
Sensex Return 12m (%)	62.4	RoE (%)	15.9	17.0	9.7	10.1

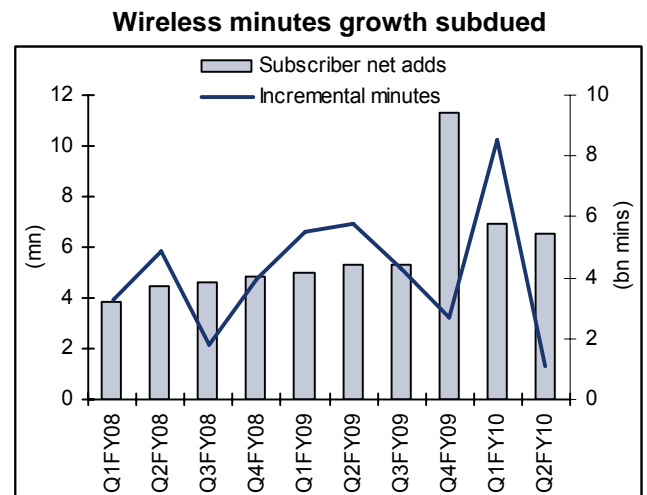
Wireless KPIs topple

- Wireless revenues declined 16.3% QoQ and 7.5% YoY to Rs41.1bn, in spite of 6.5mn quarterly net adds, mostly on account of hypercompetition and increasing dual-SIM usage.
- The management attributed the decline in wireless revenues partly to ~Rs8bn reduction in revenues from sale of CDMA equipment and decline in VAS revenues on account of more stringent VAS policies by the Telecom Regulatory Authority of India (TRAI). As per the management, wireless voice revenues grew 4% QoQ.
- Wireless KPIs fell sharply with ARPUs down 23.3% QoQ to Rs161/month (I-Sec: Rs202/month), MoUs down 6.8% QoQ to 340mins/month (I-Sec: Rs361/month) and ARPMs down 18.3% QoQ to Rs0.47/min. Total wireless minutes increased only 1.1% QoQ to Rs84.4bn. EBITDA/min declined 29.9% QoQ to Rs0.16/min.

Chart 1: Wireless KPIs fall sharply

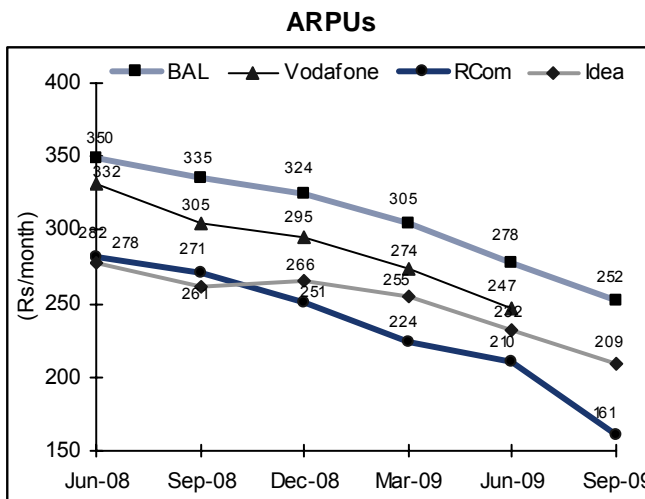


Source: Company data, I-Sec Research

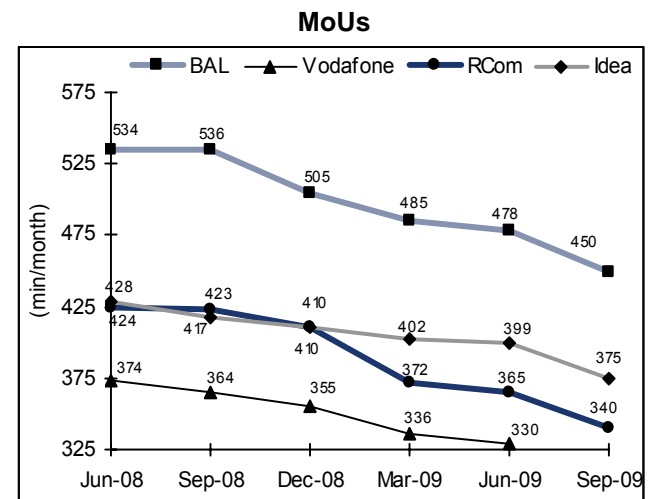


Source: Company data, I-Sec Research

Chart 2: RCom – Worst QoQ decline in ARPUs & MoUs among peers



Source: Company data, I-Sec Research



Source: Company data, I-Sec Research

Non-wireless revenues better than expected

- Globalcom revenues grew 20.2% QoQ and 33.9% YoY to Rs22,643mn (I-Sec: 19,836mn) and Broadband revenues rose 12.5% QoQ and 27.8% YoY to Rs7,700mn (I-Sec: 6,917mn).
- Others segment revenues of Rs2,760mn were down 0.9% QoQ, normalising for the Rs244.9mn gain on FCCB repurchase in Q1FY10. Costs in Others segment were also down 9.2% QoQ, leading to lower losses QoQ.

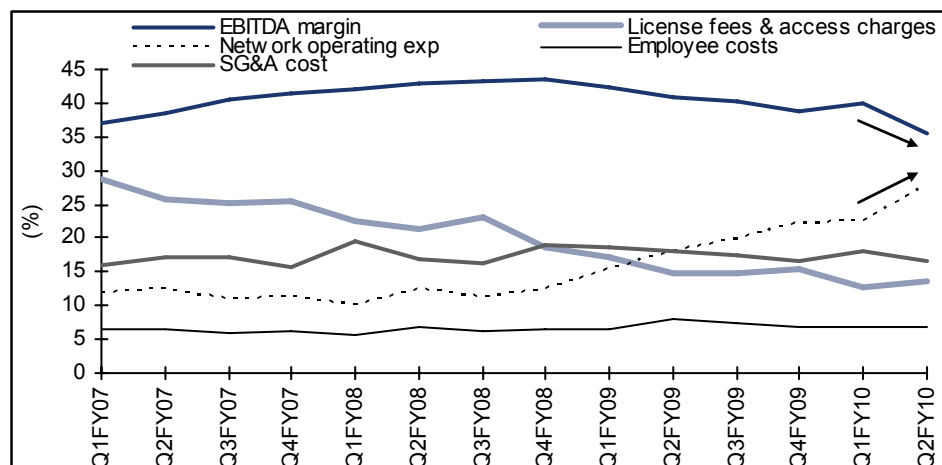
Table 1: Non-wireless segment results

Globalcom	Q2FY08	Q3FY08	Q4FY08	Q1FY09	Q2FY09	Q3FY09	Q4FY09	Q1FY10	Q2FY10
NLD mins	5,853	5,795	5,964	6,641	7,856	8,576	9,090	10,349	11,205
% growth	3.8	(1.0)	2.9	11.4	18.3	9.2	6.0	13.9	8.3
ILD mins	1,688	1,747	1,769	1,726	1,946	1,906	1,983	2,209	2,165
% growth	6.2	3.5	1.3	(2.4)	12.7	(2.1)	4.0	11.4	(2.0)
Revenues	13,161	13,299	15,257	15,260	16,915	16,783	18,803	18,844	22,643
% growth	1.0	1.0	14.7	0.0	10.8	(0.8)	12.0	0.2	20.2
Operating expenses	9,885	9,871	11,168	12,038	13,307	12,468	13,778	14,329	17,416
EBITDA	3,276	3,428	4,089	3,222	3,608	4,315	5,025	4,515	5,227
<i>EBITDA margin (%)</i>	24.9	25.8	26.8	21.1	21.3	25.7	26.7	24.0	23.1
Broadband									
Access lines	792	901	1,031	1,147	1,259	1,335	1,385	1,422	1,439
Net adds	87	109	130	116	112	76	50	37	17
ARPL	1,948	1,797	1,760	1,715	1,668	1,681	1,735	1,626	1,794
% growth	1.0	(7.8)	(2.1)	(2.6)	(2.7)	0.8	3.2	(6.3)	10.3
Revenues	4,371	4,564	5,100	5,603	6,023	6,541	7,075	6,842	7,700
% growth	14.0	4.4	11.7	9.9	7.5	8.6	8.2	(3.3)	12.5
Operating expenses	2,269	2,342	2,608	2,889	3,082	3,781	3,915	3,848	4,501
EBITDA	2,102	2,222	2,492	2,714	2,941	2,760	3,160	2,994	3,199
<i>EBITDA margin (%)</i>	48.1	48.7	48.9	48.4	48.8	42.2	44.7	43.8	41.5
Others									
Revenues	1,087	1,544	683	1,437	2,346	3,183	3,132	3,031	2,760
% growth	9.8	42.0	(55.8)	110.4	63.3	35.7	(1.6)	(3.2)	(8.9)
Operating expenses	1,653	1,802	798	1,437	2,544	3,288	4,109	4,412	4,005
EBITDA	(566)	(258)	(115)	-	(198)	(105)	(977)	(1,381)	(1,244)
<i>EBITDA margin (%)</i>	(52.1)	(16.7)	(16.8)	0.0	(8.4)	(3.3)	(31.2)	(45.6)	(45.1)

Source: Company data, I-Sec Research

EBITDA down QoQ on lower revenues & higher network opex

- Consolidated EBITDA declined 17.6% QoQ and 12.2% YoY to Rs20,199mn, 13.2% lower than our estimates of Rs23,270mn.
- EBITDA margin contracted 450bps QoQ to 35.4% (I-Sec: 39.6%) on account of 14.9% QoQ increase in network operating expenses. Wireless EBITDA margin declined 580bps QoQ to 32.7%, lowest in the past 15 quarters.
- As per the management, increase in network operating expenses was on account of the expenses on the GSM network coming in fully from the quarter, higher power & fuel costs and some one-time costs on the Flag network.

Chart 3: EBITDA margin declines QoQ on higher network operating expenses

Source: Company data, I-Sec Research

Lower depreciation & negative taxes mitigate impact on PAT

- In spite of lower depreciation and negative taxes of Rs1.74bn, reported PAT declined 54.9% QoQ and 53.4% YoY to Rs7.4bn. Depreciation of Rs7.1bn was down 35.9% QoQ on account of a technical reassessment, which led to useful life of telecom equipment being increased to 18 years.
- If the earlier depreciation schedule had been followed, depreciation for Q2FY10 would have been higher Rs3,760mn, leading to Rs3,643mn PAT.
- RCom reported net finance & interest expenses of Rs6.6bn compared with net finance & interest income reported in the past many quarters. In Q1FY10, RCom had changed the accounting policy to AS-11 from Schedule VI for accounting forex fluctuations related to foreign currency debt for acquisition of fixed assets.

Low capex is a positive, but balance sheet concerns remain

- Q2FY10 capex remained low at Rs9,823mn. H1FY10 capex of Rs19.6bn is <20% of the management capex guidance of Rs100bn for FY10. In FY09, RCom had incurred Rs194bn capex, significantly lower than capex guidance of Rs250bn.
- Cash-on-books as of end-Q1FY10 was Rs44bn and debt was Rs255bn, implying net debt of Rs211bn as of end-Q2FY10 versus Rs222bn as of end-Q1FY10. Net debt/EBITDA was 2.4x as of end-Q2FY10.
- CWIP remained high at Rs106bn as of end-Q2FY10. As and when CWIP is moved to gross block, depreciation would increase, thereby impacting the bottomline.
- Though current liabilities have slightly declined from the peak of Rs273bn as of end-Q3FY09, they continue to remain high at Rs228bn as of end-Q2FY10. Unwinding of current liabilities would lead to significant cash outflows.

Table 2: Q2FY10 results review (consolidated)*(Rs mn, year ending March 31)*

	I-Sec estimates	Q2FY10	Q2FY10	Q1FY10	YoY(%)	QoQ(%)	YTD FY10*	YTD FY09*	YoY(%)
Wireless	50,224	40,100	43,356	47,931	(7.5)	(16.3)	88,031	84,543	4.1
Global	19,386	22,643	16,915	18,844	33.9	20.2	41,487	32,175	28.9
Broadband	6,917	7,700	6,023	6,842	27.8	12.5	14,542	11,626	25.1
Less: Intersegment eliminations	(15,688)	(16,177)	(12,190)	(15,196)	32.7	6.5	(31,373)	(22,455)	39.7
Other operational income	3,061	2,760	2,346	3,031	17.6	(8.9)	5,791	3,783	53.1
Total revenues	63,900	57,026	56,450	61,452	1.0	(7.2)	118,478	109,672	8.0
License fees & access charges	9,521	7,685	8,324	7,845	(7.7)	(2.0)	15,530	17,483	(11.2)
Network operating costs	13,419	15,919	10,266	13,856	55.1	14.9	29,775	18,394	61.9
Employee costs	4,409	3,816	4,589	4,112	(16.8)	(7.2)	7,928	8,106	(2.2)
SG&A costs	11,246	9,407	10,255	11,114	(8.3)	(15.4)	20,521	20,171	1.7
Total operating expenses	38,596	36,827	33,434	36,927	10.1	(0.3)	73,754	64,154	15.0
EBITDA	25,305	20,199	23,016	24,525	(12.2)	(17.6)	44,724	45,518	(1.7)
Depreciation & Amortisation	11,590	7,144	9,180	11,144	(22.2)	(35.9)	18,288	17,818	2.6
Net interest & finance charges	2,000	6,551	(2,353)	(6,205)	(378.4)	(205.6)	346	(4,693)	(107.4)
PBT	11,715	6,504	16,189	19,586	(59.8)	(66.8)	26,090	32,393	(19.5)
Exceptional items	-	29	647	111			140	1,287	(89.1)
Less: Provision for Tax	1,406	(1,739)	(567)	2,267	206.7	(176.7)	528	(761)	(169.4)
Minority interest	505	811	800	842	1.4	(3.7)	1,653	1,435	15.2
Reported PAT	9,804	7,403	15,309	16,366	(51.6)	(54.8)	23,769	30,432	(21.9)
Adjusted PAT	9,804	7,432	15,956	16,477	(53.4)	(54.9)	23,909	31,719	(24.6)
Operating Margin (%)	39.6	35.4	40.8	39.9			37.7	41.5	
Personnel exp to Revenues (%)	17.6	16.5	18.2	18.1			17.3	18.4	
Effective tax rate (%)	12.0	(26.7)	(3.5)	11.6			2.0	(2.3)	
NPM (%)	15.3	13.0	28.3	26.8			20.2	28.9	

Source: Company data, I-Sec Research

RCom refutes discrepancies in accounts revealed by DoT-appointed special auditors

According to media reports, the DoT-appointed special auditor Parekh & Company has revealed that RCom has: i) inflated its wireless revenues by Rs291.5mn in FY08, ii) evaded licence fees of Rs31.5mn, iii) accounted Rs61mn revenues twice in two different accounting years and iv) falsely reported Rs37.9mn by selling expired pre-paid cards to two companies – Macronet and Inference Systems.

The DoT confirmed receipt of the report by auditors and the report would be examined by a four-member committee of DoT, headed by Member (Finance). The DoT is awaiting auditors' reports on four other Telecom companies as well – Tata Teleservices, Bharti Airtel, Vodafone and Idea.

RCom's management has commented that the alleged remarks by the special auditor are completely unilateral, biased and prejudiced. The management also reiterated that RCom's accounts: i) contained no irregularity or discrepancy, ii) were duly audited by auditors such as KPMG, iii) have been subjected to the peer group review by auditors appointed by SEBI as recently as in May '09, iv) were prepared in accordance with Indian GAAP accounting standards and principles and v) were in line with telecom and general industry practice.

Earnings revision

We reduce FY10E & FY11E estimates 20.2% & 8.9% respectively after factoring in steep declines in ARPMs & MoUs, given the ongoing price war in the Telecom sector. Our new EPS estimates for FY10E & FY11E are Rs20.9 & Rs23.9 respectively.

Table 3: Earnings revision (consolidated)

(Rs mn)

	FY10E			FY11E		
	Revised	Old	% change	Revised	Old	% change
Sales	233,864	280,315	(16.6)	268,600	322,639	(16.7)
EBITDA	85,627	112,244	(23.7)	104,037	132,605	(21.5)
PAT	43,204	54,125	(20.2)	49,351	54,158	(8.9)

Source: Company data, I-Sec Research

Downgrade to SELL from Hold

RCom faces steep challenges ahead as it struggles to juggle its business case between two networks by trying to grow voice usage on GSM and data usage on CDMA. We are yet to see the impact of pay-per-second plans and *Simply Reliance* on ARPMs Q3FY10 onwards. Concerns over RCom's accounts remain given the findings of the DoT-selected special auditors, as per recent media reports. We downgrade RCom to SELL from Hold with revised target price of Rs175/share (earlier Rs285/share), an 15% discount to our DCF-based valuation of Rs206/share. We await further clarity on RCom's accounts.

Financial Summary

Table 4: Profit & Loss statement

(Rs mn, year ending March 31)

	FY08	FY09	FY10E	FY11E
Operating Income (Sales)	188,274	222,506	233,864	268,600
Operating Expenses	108,687	136,435	148,237	164,563
EBITDA	79,587	86,070	85,627	104,037
% margins	42.3	38.7	36.6	38.7
Depreciation & Amortisation	28,053	36,077	33,679	34,874
Net Interest	(3,997)	(5,070)	6,456	13,016
Other Income	2,404	6,979	3,490	3,559
Recurring PBT	57,935	62,042	48,982	59,707
Add: Extraordinaries	12,828	(75)	-	-
Less: Taxes	2,836	(518)	5,761	10,075
- Current tax	1,835	490	5,761	10,075
- Deferred tax	1,002	(1,008)	-	-
Less: Minority Interest	13,915	2,036	17	281
Net Income (Reported)	54,011	60,449	43,204	49,351
Recurring Net Income	41,184	60,524	43,204	49,351

Source: Company data, I-Sec Research

Table 5: Balance sheet

(Rs mn, year ending March 31)

	FY08	FY09	FY10E	FY11E
Assets				
Total Current Assets	105,817	147,145	210,033	155,595
of which cash & cash eqv.	8,782	16,829	103,918	39,362
Total Current Liabilities & Provisions	200,776	200,814	212,588	193,917
Net Current Assets	(94,959)	(53,669)	(2,555)	(38,322)
Investments				
of which	109,996	95,657	95,657	95,657
Strategic/Group				
Other Marketable	109,996	95,657	95,657	95,657
Net Fixed Assets	523,126	727,053	759,160	784,559
of which				
Capital Work-in-Progress	149,299	113,096	47,579	45,205
Goodwill	35,654	52,215	52,215	52,215
Total Assets	573,817	821,256	904,477	894,109
Liabilities				
Borrowings	258,217	391,623	431,623	371,623
Deferred Tax Liability	-	-	-	-
Minority Interest	24,309	6,549	6,566	6,847
Equity Share Capital	10,320	10,320	10,320	10,320
Face Value per share (Rs)	5	5	5	5
Reserves & Surplus*	304,253	419,032	462,253	511,885
Net Worth	290,263	422,803	466,007	515,358
Total Liabilities	573,817	821,256	904,477	894,109

Source: Company data, I-Sec Research

Table 8: Quarterly trend

(Rs mn, year ending March 31)

	Dec-08	Mar-09	Jun-09	Sep-09
Net sales	58,502	61,237	61,452	57,026
% growth (YoY)	20.0	15.3	15.5	1.0
EBITDA	23,525	23,832	24,525	20,199
Margin (%)	40.2	38.9	39.9	35.4
Other income	0	0	0	0
Add: Extraordinaries	(358)	1,570	(111)	(29)
Net profit	14,460	12,974	16,477	7,432

Source: Company data

Table 6: Cashflow statement

(Rs mn, year ending March 31)

	FY08	FY09	FY10E	FY11E
Operating Cash flow	87,332	106,156	73,411	80,946
Working Capital Changes	1,382	(33,243)	35,975	(28,789)
Capital Commitments	(226,338)	(255,510)	(65,786)	(60,273)
Free Cash Flow	(137,624)	(182,597)	43,599	(8,115)
Cash flow from Investing				
Activities	(30,479)	21,319	3,490	3,559
Issue of Share Capital	97	-	-	-
Repayment of borrowing	-	-	-	-
Inc (Dec) in Borrowings	83,834	133,406	40,000	(60,000)
Dividend paid	(1,811)	(1,932)	-	-
Extraordinary Items	22,758	37,852	-	-
Chg. in Cash & Bank balance	(63,225)	8,047	87,089	(64,556)

Source: Company data, I-Sec Research

Table 7: Key ratios

(Year ending March 31)

	FY08	FY09	FY10E	FY11E
Per Share Data (Rs)				
Recurring EPS	20.0	29.3	20.9	23.9
Reported EPS	26.2	29.3	20.9	23.9
Recurring Cash EPS	33.5	46.8	37.2	40.8
Dividend per share (DPS)	0.8	0.8	-	-
Book Value per share (BV)	140.6	204.8	225.8	249.7
Growth Ratios (%)				
Operating Income	9.5	18.2	5.1	14.9
EBITDA	22.9	8.1	(0.5)	21.5
Recurring Net Income	13.1	47.0	(28.6)	14.2
Diluted Recurring EPS	12.1	47.0	(28.6)	14.2
Diluted Recurring CEPS	4.6	39.5	(20.4)	9.5
Valuation Ratios (x)				
P/E	8.8	6.0	8.4	7.4
P/CEPS	5.2	3.8	4.7	4.3
P/BV	1.3	0.9	0.8	0.7
EV / EBITDA	8.1	7.5	7.5	6.2
EV / Operating Income	3.4	2.9	2.7	2.4
EV / Operating FCF	(4.7)	(3.5)	14.7	(79.2)
Operating Ratio				
Network costs/Sales (%)	11.7	19.8	25.7	24.3
SG&A/Sales (%)	21.6	16.0	13.6	13.3
Other Income / PBT (%)	4.1	11.2	7.1	6.0
Effective Tax Rate (%)	4.9	(0.8)	11.8	16.9
NWC / Total Assets (%)	(18.1)	(8.6)	(11.8)	(8.7)
Inventory Turnover (days)	7.9	8.9	7.9	7.9
Receivables (days)	44.1	54.8	50.5	35.1
Payables (days)	454.3	422.6	396.6	330.2
Net D/E (%)	48.0	66.0	49.8	45.9
Return/Profitability Ratio (%)				
Recurring Net Income Margins	21.6	26.4	18.2	18.1
RoCE	7.6	7.9	5.7	6.7
RoNW	15.9	17.0	9.7	10.1
Dividend Payout Ratio	3.8	2.7	-	-
Dividend Yield	42.6	45.5	-	-
EBITDA Margins	42.3	38.7	36.6	38.7

Source: Company data, I-Sec Research

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I-Sec investment ratings (all ratings relative to Sensex over next 12 months)

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