9 April 2007 | 13 pages

Reliance Communications (RLCM.BO)

Buy: Leverage to Growth Stays Despite Headwinds

Rating change ☐
Target price change ☑
Estimate change ☑

- Target adjusted to Rs510 — This is based on an EV/EBITDA of 9.7x FY09E, a 15% discount to Bharti, factoring in the challenges inherent in RCOM's proposed GSM plans, including spectrum-related delays. We believe that the current large valuation discount to Bharti (25-30% on EV/EBITDA) adequately factors in the shortcomings without building any potential positive triggers.

- GSM rollout delayed? — GSM overlay plans appear to be slightly delayed for reasons not under the company's control, i.e. spectrum release and the allocation criterion. Further delays would increase the opportunity cost besides leading to lumpy GSM capex, when it happens. RCOM's current valuation discount to Bharti factors in these potential risks, in our view.

- Earnings adjusted for non-operational items — We adjust our FY07E-09E earnings up to reflect forex gains and lower net debt. Our new estimates reflect EBITDA and earnings FY07-09 CAGRs of 37.4% and 39.0% respectively, based on conservative sub adds and margins. RCOM thus continues to benefit from wireless growth, but accompanied by higher risks.

- Recent de-activations more a clean-up than anything else — RCOM has deactivated 15% of its subscribers post the re-verification. Being inactive subs, the disconnections would, however, be revenue and profit neutral. We expect RCOM to maintain reasonably healthy sub adds (1.2m in March).

Buy/Medium Risk	1M
Price (09 Apr 07)	Rs405.00
Target price	Rs510.00
from Rs570.00	
Expected share price return	25.9%
Expected dividend yield	0.5%
Expected total return	**26.4%**
Market Cap	Rs828,069M
	US$19,406M

Price Performance (RIC: RLCM.BO, BB: RCOM IN)

See Appendix A-1 for Analyst Certification and important disclosures.

Figure 1. Statistical Abstract

Year to 31 Mar	EBITDA (Rs m)	Net Profit (Rs m)	FD EPS (Rs)	EPS Growth (%)	P/E (x)	EV/EBITDA (x)	Price/CEPS (x)
2006P	24,786	4,823	2.4	na	168.3	34.1	37.2
2007E	57,500	30,577	15.0	534.0	26.5	14.5	14.6
2008E	83,372	44,879	21.9	46.8	18.1	9.9	10.4
2009E	108,613	59,060	28.9	31.6	13.7	7.5	8.1

Source: Citigroup Investment Research estimates

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Fiscal year end 31-Mar	2005	2006	2007E	2008E	2009E
Valuation Ratios					
P/E adjusted (x)	na	171.7	27.1	18.5	14.0
EV/EBITDA adjusted (x)	na	na	15.4	10.7	8.2
P/BV (x)	na	7.0	5.8	4.6	3.6
Dividend yield (%)	na	0.0	0.5	0.7	1.0
Per Share Data (Rs)					
EPS adjusted	na	2.36	14.96	21.95	28.89
EPS reported	na	2.36	14.96	21.95	28.89
BVPS	na	57.48	70.18	88.76	113.14
DPS	na	0.00	2.00	3.00	4.00
Profit & Loss (RsM)					
Net sales	na	112,884	144,650	195,202	238,554
Operating expenses	na	-105,085	-112,201	-144,755	-171,282
EBIT	**na**	**7,799**	**32,448**	**50,448**	**67,272**
Net interest expense	na	-2,649	-925	-1,131	-764
Non-operating/exceptionals	na	0	0	0	0
Pre-tax profit	**na**	**5,150**	**31,523**	**49,317**	**66,509**
Tax	na	-327	-946	-4,439	-7,449
Extraord./Min.Int./Pref.div.	na	0	0	0	0
Reported net income	**na**	**4,823**	**30,577**	**44,879**	**59,060**
Adjusted earnings	na	4,823	30,577	44,879	59,060
Adjusted EBITDA	na	24,786	57,500	83,372	108,613
Growth Rates (%)					
Sales	na	na	28.1	34.9	22.2
EBIT adjusted	na	na	316.1	55.5	33.4
EBITDA adjusted	na	na	132.0	45.0	30.3
EPS adjusted	na	na	534.0	46.8	31.6
Cash Flow (RsM)					
Operating cash flow	**na**	**21,810**	**115,033**	**101,843**	**114,188**
Depreciation/amortization	na	16,987	25,052	32,925	41,341
Net working capital	na	0	58,479	22,909	13,024
Investing cash flow	**na**	**0**	**-96,378**	**-91,629**	**-94,171**
Capital expenditure	na	0	-96,378	-91,629	-94,171
Acquisitions/disposals	na	0	0	0	0
Financing cash flow	**na**	**0**	**14,498**	**-8,031**	**-9,964**
Borrowings	na	0	20,024	0	0
Dividends paid	na	0	-4,600	-6,901	-9,201
Change in cash	**na**	**21,810**	**33,153**	**2,182**	**10,053**
Balance Sheet (RsM)					
Total assets	**na**	**319,738**	**431,492**	**494,789**	**562,583**
Cash & cash equivalent	na	60,038	93,065	95,248	105,300
Accounts receivable	na	16,807	20,090	18,978	19,879
Net fixed assets	na	214,263	285,590	344,294	397,124
Total liabilities	**na**	**202,223**	**288,000**	**313,319**	**331,254**
Accounts payable	na	89,956	130,000	155,319	173,254
Total Debt	na	92,976	113,000	113,000	113,000
Shareholders' funds	**na**	**117,515**	**143,492**	**181,470**	**231,329**
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	na	22.0	39.8	42.7	45.5
ROE adjusted	na	na	23.4	27.6	28.6
ROIC adjusted	na	na	16.7	20.4	22.7
Net debt to equity	na	28.0	13.9	9.8	3.3
Total debt to capital	na	44.2	44.1	38.4	32.8

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Valuation: Factors in the risks

RCOM's valuation discount to Bharti has widened over the past 3 months, post the Vodafone-Hutch deal and the subsequent decline in RCOM's sub adds. The stock currently trades at a steep 25-30% discount to Bharti, which we believe factors in the risks accompanying RCOM's proposed shift from CDMA to GSM.

Our new target price for RCOM is based on an EV/EBITDA of 9.7x, a 15% discount to Bharti's target multiples (ex-towerco). We believe this valuation framework adequately captures the technological challenge faced by RCOM, which is partly offset by the support from liquidity overflow due to Bharti's foreign shareholding limit. We are not valuing RCOM's tower business due to a) lower numbers of existing towers vis-à-vis Bharti, b) the lack of clarity on the timing of the GSM rollout, and c) Bharti's headstart with the Vodafone-MOU.

Figure 2. Valuation Comparison (at prices as on April 5, 2007)

	EV/EBITDA (x)		P/E (x)		P/CEPS (x)		EBITDA CAGR (FY07-09E)	EPS CAGR (FY07-09E)
	2008E	2009E	2008E	2009E	2008E	2009E		
Bharti	13.3x	10.6x	23.4x	19.4x	14.8x	12.0x	34.6%	32.8%
RCOM	9.9x	7.5x	18.1x	13.7x	10.4x	8.1x	37.4%	39.0%
% prem/(disc) to Bharti	-25%	-29%	-23%	-29%	-30%	-33%		

Source: Citigroup Investment Research estimates CMP as on April 5, 2007, Bharti=Rs746, RCOM=Rs397

Figure 3. Valuation Comparison (at target prices)

	EV/EBITDA (x)		PER (x)		P/CEPS (x)		EBITDA CAGR (FY07-09E)	EPS CAGR (FY07-09E)
	2008E	2009E	2008E	2009E	2008E	2009E		
Bharti*	14.2x	11.3x	25.1x	20.8x	15.9x	12.9x	34.6%	32.8%
RCOM	12.7x	9.7x	23.2x	17.7x	13.4x	10.4x	37.4%	39.0%
% prem/(disc) to Bharti	-10%	-15%	-7%	-15%	-16%	-19%		

Source: Citigroup Investment Research estimates *At core business value target of Rs800 (ex-towerco)

GSM rollout: Delay will dilute the stated logic

RCOM's GSM rollout plans remain contingent (as for all new entrants) on the timing of the spectrum release from Defence, which has been delayed. As things stand today on the proposed plan to shift the Defence to alternative communication links, we expect the spectrum to be released in 2H FY08. Moreover, the issue of spectrum allocation (once it is released) is still not resolved with what stance the DoT will likely take on RCOM's application vis-à-vis incumbents and new GSM aspirants (viz. Maxis). Further delays would hurt RCOM's stated logic for a shift to GSM, i.e. maximise subscriber market share, which at some level is being constrained by CDMA.

- Any delay is therefore an opportunity cost especially as stronger GSM players i.e. Vodafone, would make their presence felt in the next 6-9 months.

- Delays would also lead to bunching up of GSM capex (whenever the rollout commences) as the network coverage in the 16 new circles would have to be on a par with the best. Bharti's wireless capex over FY06-08E would be >US$4.0bn, which gives an indication of the potential lumpiness of GSM capex, possible in FY09E. Our estimate for RCOM's wireless capex at US$1.8bn per year over FY08-09 does not fully cover this risk.

Figure 4. Bharti's Wireless Capex

	FY06	FY07E	FY08E
Wireless Capex (US$m)	978	1716	1847

Source: Company Reports and Citigroup Investment Research estimates

Customer verification: Clean-up more than anything else

RCOM, in a recent release, stated that it completed the re-verification of only 85% of its sub base until the stipulated deadline of 31 March, leading to de-activation of the remaining 15%. This translates to roughly 5m subs on the unadjusted gross sub base of about 33.6m as on 31 March 2007.

However, according to RCOM, the de-activated customers did not contribute any revenues in 3Q FY07. Besides, there is unlikely to be any revenue write-offs as these subs were inactive for the past few quarters. We therefore see RCOM using the current verification drive as an excuse to clean up its books. RCOM claims ARPUs will be up 12% as a result, acting as a further proof of the inactive subs. No further details on mix of inactive subs (scheme specific, post/pre mix, period of adds, etc.) were provided.

What does it change? — Nothing much as far as revenue market share is concerned. RCOM's share of subs would, however, drop from 20.6% to 18.0% (besides the share of its past net adds being overstated), making Bharti a clear leader. Bharti's revenue market share of 25.4% as against subs share of 22.5% had acted as an indication of the true picture earlier.

What does it do to earnings? — While the de-activations will likely impact sentiment toward the stock, they do not impact our estimates.

Earnings revision — mainly to factor in forex-related items

Our EBITDA estimates remain more or less unchanged – lower sub base due to de-activations is made up by the resultant higher ARPUs. However, we have adjusted our EPS estimates upwards especially for FY07-08 to account for higher-than-expected forex gains from rupee appreciation and lower than expected net debt.

Figure 5. Earnings Revision

	Net Profit	EPS	% Change	EBITDA
FY07E	30,577	15.0	9.2	57,500
Old	28,085	13.7		57,231
FY08E	44,879	21.9	5.5	83,372
Old	42,431	20.8		82,645
FY09E	59,060	28.9	0.3	108,613
Old	58,802	28.8		108,215

Source: Citigroup Investment Research estimates

Annexure 1: Financial statements

Figure 6. Income Statement (Rs. m)

Year to 31 March	FY06	FY07E	FY08E	FY09E
Total Revenue	112,884	144,650	195,202	238,554
Wireless	74,070	107,440	155,019	194,902
Global Business	59,048	53,029	61,973	69,749
Broadband	5,128	11,732	15,392	19,342
Others	19,200	-	-	-
Eliminations	(44,562)	(27,552)	(37,181)	(45,439)
Total Cost	(88,098)	(87,150)	(111,830)	(129,941)
Access & IUC	(31,012)	(44,950)	(57,944)	(69,012)
License Fees	(8,559)	(10,621)	(15,139)	(19,291)
Other Operating Exp	(48,527)	(58,381)	(75,929)	(87,076)
EBITDA	24,786	57,500	83,372	108,613
Wireless	22,411	39,617	57,455	74,830
Global Business	5,922	13,479	18,237	23,369
Broadband	746	5,349	7,913	10,694
Others	-	(194)	(233)	(280)
Eliminations	(4,293)	(750)	-	-
EBITDA Margin (%)	22.0	39.8	42.7	45.5
Wireless (%)	30.3	36.9	37.1	38.4
Global Business (%)	10.0	25.4	29.4	33.5
Broadband (%)	14.5	45.6	51.4	55.3
Net Interest	(2,649)	(925)	(1,131)	(764)
Depreciation & Amortization	(16,987)	(25,052)	(32,925)	(41,341)
PBT	5,150	31,523	49,317	66,509
Tax	(327)	(946)	(4,439)	(7,449)
PAT	4,823	30,577	44,879	59,060
No. of Shares	2,045	2,045	2,045	2,045
EPS	2.4	15.0	21.9	28.9
DPS	-	2.0	3.0	4.0

Source: Citigroup Investment Research estimates

Figure 7. Summary Balance Sheet

As at 31 March	FY06	FY07E	FY08E	FY09E
Equity	10,223	10,223	10,223	10,223
Reserves and Surplus	107,292	133,269	171,247	221,106
Shareholders funds	117,515	143,492	181,470	231,329
Debt	92,976	113,000	113,000	113,000
Secured Loans	87,185	68,000	68,000	68,000
Foreign Currency Loans	35,079	21,000	21,000	21,000
Rupee Loans	52,106	47,000	47,000	47,000
Unsecured Loans	5,791	45,000	45,000	45,000
Current Liabilities	89,956	130,000	155,319	173,254
Provisions	19,291	45,000	45,000	45,000
Total Liabilities	319,738	431,492	494,789	562,583
Fixed Assets	230,531	308,214	399,843	494,014
Accumulated Depreciation	(47,573)	(72,625)	(105,549)	(146,890)
Net Fixed Assets	182,958	235,590	294,294	347,124
CWIP	31,305	50,000	50,000	50,000
Investments	121	247	247	247
Cash	60,038	93,065	95,248	105,300
Current Assets	45,316	52,590	55,001	59,912
Inventories	4,076	3,000	5,000	5,500
Debtors	16,807	20,090	18,978	19,879
Other Current Assets	765	4,500	1,200	1,400
Loans & Advances	23,668	25,000	29,823	33,132
Total Assets	319,738	431,492	494,789	562,583

Source: Citigroup Investment Research estimates

Figure 8. Summary Cash Flow

Year to 31 March	FY07E	FY08E	FY09E
PAT	30,577	44,879	59,060
Add: Depreciation	25,052	32,925	41,341
Change in NWC	58,479	22,909	13,024
Add: Interest	925	1,131	764
Operating Cash Flow	115,033	101,843	114,188
Capex	96,378	91,629	94,171
Free Cash Flow	18,655	10,214	20,017
Cash flow into investments	(96,378)	(91,629)	(94,171)
Increase in debt	20,024	-	-
Increase in Equity	-	-	-
Less: Interest	(925)	(1,131)	(764)
Less: Dividend	(4,600)	(6,901)	(9,201)
Financial cash flow	14,498	(8,031)	(9,964)
Cash year begin	60,038	93,065	95,248
Cash generated	33,027	2,182	10,053
Cash year end	93,065	95,248	105,300

Source: Citigroup Investment Research estimates

Company description

RCOM is an integrated player in the Indian telecoms sector. It was listed on the Indian stock exchanges following the de-merger of Reliance Industries. RCOM is the second-largest player in the mobile segment, has an 80,000km-long India-wide optic-fiber network and owns the FLAG submarine cable network. It plans to launch IPTV and retail broadband in 2007. RCOM has 3 business units 1) Wireless, which includes a nationwide wireless network on CDMA and GSM; 2) Global Business comprising wholesale voice and data; and 3) Broadband for both retail and enterprise.

Investment thesis

We rate RCOM as Buy/Medium Risk (1M). Continued expansion of the wireless market and RCOM's ability to capture market share profitably will, in our view, be a recurring theme for the stock. The wireless business has shown higher operating leverage recently and has maintained similar return parameters despite lower revenue yields. Competitive pressures, though intense, should continue to be rational. RCOM is planning a GSM overlay on its existing CDMA network; while there is market rationale for this (GSM has lower-priced handsets), we think the economic rationale would be determined by the deal from vendors as well as the extent of infrastructure-sharing possible. Most regulatory concerns appear behind us, and news flow is likely to be positive. The company has yet to realize the benefits of full utilization of its network infrastructure (especially in broadband); we expect significant strengthening of margins as traffic increases across segments. We expect RCOM to register an EBITDA CAGR of 37.4% and EPS CAGR of 39.0% for FY07-09.

Valuation

We value Indian wireless plays on DCF given the back-ended nature of profits and cash flow. For RCOM, however, we use EV/EBITDA in the absence of a detailed balance sheet. Our 12-month target price of Rs510 is based on 9.7x FY09E EV/EBITDA, a 15% discount to Bharti's target multiple (ex- towerco). We are now assuming a 15% discount to Bharti as against par valuations earlier (i.e. EV/EBITDA of 11.2x FY09E) to reflect the uncertainty on the timing of the GSM rollout and the associated challenges. We expect RCOM's valuation multiples to be determined by Bharti's due to the liquidity overflow from the latter, notwithstanding the risk of technology transition. Meanwhile, higher-than-average earnings growth (CAGR of 39.0% over FY07-09E) and low sensitivity of wireless demand to interest rates should continue to support premium valuations for the sector.

Risks

Our risk-rating system, which tracks 260-day share price volatility, assigns a High Risk rating to RCOM, but we believe Medium Risk is more appropriate. RCOM has been de-merged from Reliance Industries, and its shareholding at the time of listing mirrored the holding of RIL. The stock is therefore unlikely to have risks that are typical of newly listed companies. Besides, growth in the telecoms sector gives visibility to RCOM's prospects. But we believe its evolving financial history and risks pertaining to GSM overlay warrant a risk rating higher than the Low Risk assigned to Bharti. Downside risks to our target price include smaller-than-expected market share, lower-than-anticipated operating leverage (especially in FY07), cost-overruns n GSM overlay, regulatory and competition risks, un-remunerative capex, delays in the ongoing re-organization and more telecom-related paper.

Bharti (BRTI.BO - Rs752.25; 1L)

Valuation: Our 12-month forward target price of Rs960 is based on core DCF of Rs800 and a towerco option value of Rs158. The core DCF (as on March-08) is based on a WACC of 10.8%, a terminal growth rate of 4% and beta of 0.9 (implying a terminal EV/EBITDA multiple of 8.5x). We prefer DCF as our primary valuation methodology because the wireless market will likely continue to see robust growth requiring upfront capex but should generate significant free cash beyond 2009-10. Our target price (net of towerco value) represents an FY09E P/E of 20.8x, P/CEPS of 12.9x and EV/EBITDA of 11.3x. The imputed target P/E (net of towerco) of 25.0x FY08E is at 25% premium to the broad market P/E (20.0x FY08E at the higher end of our Sensex target of 16,000). This, we believe, is justified by above-average earnings growth, improved earnings visibility and relative insulation from macro risks.

Risks: Our quantitative risk-rating system, which tracks 260-day share price volatility, rates Bharti as Low Risk. We are comfortable attributing a Low Risk rating for the following reasons: (1) Bharti has a track record of profitability and execution; (2) the company's capex plans are fully funded; and (3) the strategic shareholding of SingTel leaves us comfortable with execution issues and initiatives. The risks that could prevent the stock from reaching our target price include competition-led tariff pressures, un-remunerative capex, overall market downside, and slower-than-expected execution of the tower sharing initiative.

Appendix A-1

Analyst Certification

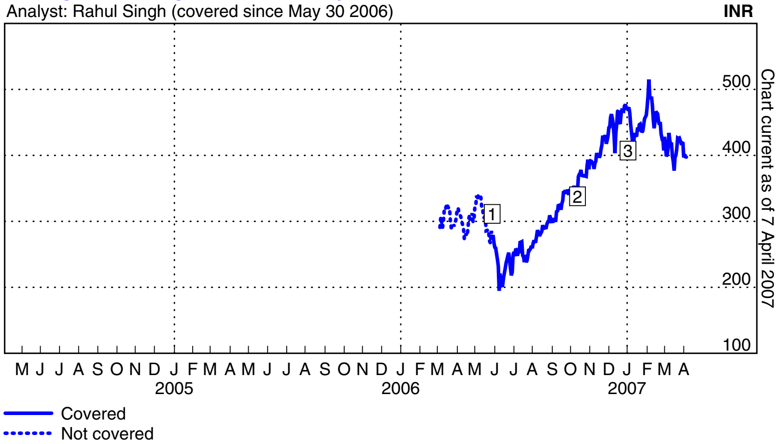
We, Rahul Singh and Anand Ramachandran, CFA, research analysts and the authors of this report, hereby certify that all of the views expressed in this research report accurately reflect our personal views about any and all of the subject issuer(s) or securities. We also certify that no part of our compensation was, is, or will be directly or indirectly related to the specific recommendation(s) or view(s) in this report.

IMPORTANT DISCLOSURES

Reliance Communications (RLCM.BO)

Ratings and Target Price History - Fundamental Research

Analyst: Rahul Singh (covered since May 30 2006)



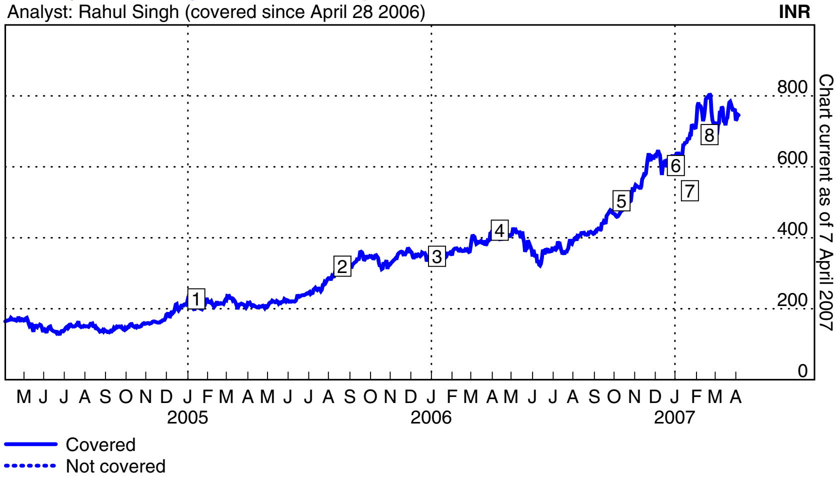
#	Date	Rating	Target Price	Closing Price
1:	29 May 06	1M	360.00	276.25
2:	12 Oct 06	1M	*430.00	345.95
3:	2 Jan 07	1M	*570.00	470.75

*Indicates change.

Bharti Airtel (BRTI.BO)

Ratings and Target Price History - Fundamental Research

Analyst: Rahul Singh (covered since April 28 2006)



#	Date	Rating	Target Price	Closing Price
1:	14 Jan 05	*1M	*260.00	210.30
2:	22 Aug 05	1M	*400.00	306.10
3:	10 Jan 06	1M	*450.00	339.25
4:	13 Apr 06	1M	*500.00	395.95
5:	12 Oct 06	*1L	*600.00	475.65
6:	2 Jan 07	1L	*750.00	633.00
7:	23 Jan 07	1L	*800.00	689.15
8:	21 Feb 07	1L	*960.00	806.30

*Indicates change.

Rahul Singh holds a long position in the shares of Bharti Airtel.

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Data current as of 31 March 2007	Buy	Hold	Sell
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% of companies in each rating category that are investment banking clients	45%	42%	32%
India -- Asia Pacific (130)	58%	14%	28%
% of companies in each rating category that are investment banking clients	42%	50%	42%

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