

Reliance Communications (RCOM IN)

Rating: **4**

Don't try to catch a falling knife

Telecommunication services: India

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Target price: **Rs130.00**

→ **Rs105.00**

Price (26 Nov)	Rs130.50
Reuters code	RLCM.NS
ADR/GDR code	n.a.
Shares per ADR/GDR	n.a.

Market data			
SENSEX Index			19,136.61
Market cap	(US\$bn)		5.87
EV	(US\$bn: 11E)		13.00
3-mth avg daily T/O	(US\$m)		20.83
Shares outstanding	(m)		2,064
Free float	(%)		32.8
Major shareholder	AAA Communications		(54.2%)
Exchange rate	Rs/US\$		45.855
Performance (%)			
Absolute	1M	3M	6M
Relative	(25.8)	(18.3)	(3.0)
	(20.4)	(23.3)	(19.8)

Source: Daiwa
Note: *Relative to SENSEX Index

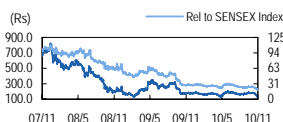
Investment indicators			
	2011E	2012E	2013E
PER (x)	19.6	18.4	13.2
PCFR (x)	4.4	3.5	3.2
EV/EBITDA (x)	9.2	8.0	6.6
PBR (x)	0.6	0.6	0.6
Dividend yield (%)	0.7	0.7	0.8
ROE (%)	3.1	3.2	4.4
ROA (%)	1.4	1.5	2.0
Net debt equity (%)	71.3	61.6	50.3
Relative to peers			Below
Relative to history			Below

Source: Daiwa forecasts

Income summary (Rs m)				
Yr to 31 Mar	2010	2011E	2012E	2013E
Revenue	214,964	207,195	224,636	246,588
YoY (%)	(3.4)	(3.6)	8.4	9.8
EBITDA	71,852	65,083	70,070	78,986
YoY (%)	(17.7)	(9.4)	7.7	12.7
Net profit	20,480	13,713	14,662	20,440
YoY (%)	(66.2)	(33.0)	6.9	39.4
EPS (Rs)	9.923	6.644	7.103	9.903
YoY (%)	(66.2)	(33.0)	6.9	39.4
CFPS (Rs)	46.339	29.554	37.516	40.580
DPS (Rs)	0.850	0.900	0.950	1.000

Source: Company, Daiwa forecasts

Price and relative performance



Source: Bloomberg, Daiwa

Forecasts revisions (%)

	FY11E	FY12E	FY13E
Revenue change	(15.1)	(23.2)	(26.5)
Net profit change	(34.7)	(41.6)	(35.9)
EPS change	(34.7)	(41.6)	(35.9)

Source: Daiwa forecasts

Fair value

Valuation (Rs/shr)	105.00
Methodology	DCF based valuation, WACC of 11%, beta of 1.0
Key assumption	ARPU to decline 23% in FY11 and 12% in FY12

Source: Daiwa forecasts

What has changed?

- We have lowered our six-month target price for Reliance Communications (RCOM) to Rs105 from Rs130, and maintain our **4** (*Underperform*) rating on the stock.

Impact

- Target price lowered.** We believe that the lacklustre revenue-growth momentum in 2Q FY11 is representative of the disappointing revenue performance seen over the past eight quarters. As a result, we have revised down our FY11-13 revenue forecasts by 15-27%. This, coupled with the high fixed-cost structure of the business – due partly to high financial leverage – drove our downward EPS forecast revisions for FY11-13.
- Declining operational momentum.** For FY11-FY13, we now forecast a 3-year revenue CAGR of 5% and a 3-year EBITDA CAGR of 3%. RCOM's operating performance has trailed that of the large incumbent operators over the past two years. With new operators lowering tariffs, we believe RCOM can no longer rely on its strategy of offering lower tariffs to attract customers to its network.
- Regulatory environment remains uncertain.** In our opinion, the recent developments related to the allotment of 2G licences and spectrum could mean prolonged uncertainty on the regulatory front. We believe the current environment could result in delays in new policy announcements and therefore possible consolidation in the sector.
- No progress on restructuring efforts.** RCOM has thus far not been successful in its efforts to unlock value by divesting its tower portfolio. Given its high financial leverage (net debt-to-EBITDA ratio of 4.7x at the end of 2Q FY11), we believe it is important for the company to restructure its balance sheet.

Valuation

- Based on our FY12 forecasts, the stock is trading currently at an FY12 EV/EBITDA and PER of 8x and 18x, respectively. Our DCF-based target price of Rs105, implies 19% downside potential for the share price.

Catalysts and action

- RCOM shares have declined by 24% YTD. Despite this, its valuations appear rich and the outlook remains unconvincing to us. Our FY12-13 net-profit forecasts are 33-34% lower than those of the Bloomberg consensus.

RCOM: changes in our estimates (Rs bn)

	FY11E			FY12E			FY13E		
	New	Prev.	% change	New	Prev.	% change	New	Prev.	% change
Revenue	207	244	(15)	225	293	(23)	247	336	(27)
EBITDA	65	81	(20)	70	96	(27)	79	107	(26)
EBITDA margin (%)	31	33		31	33		32	32	
Net profit	14	21	(35)	15	25	(42)	20	32	(36)
Operating metrics									
Subscribers (m)	129	127	2	154	146	6	178	163	9
ARPU (Rs)	122	133	(8)	107	129	(17)	99	131	(25)

Source: Daiwa forecasts

Company background

Reliance Communications (RCOM) is India's second-largest mobile-service provider in terms of subscriber terms. The company offers wireless services using both CDMA and GSM technology. Its subsidiaries include Reliance Globalcom, which operates an undersea cable and domestic fibre-optic cable network, and Reliance Infratel, which operates a passive-infrastructure business

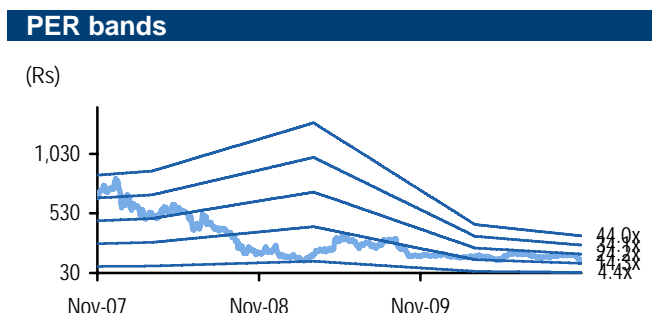
Reliance Communications – financial summary

Profit and loss (Rs m)						Balance sheet (Rs m)					
Year to 31 Mar	2009	2010	2011E	2012E	2013E	As at 31 Mar	2009	2010	2011E	2012E	2013E
Wireless	173,677	166,396	169,628	182,660	196,797	Cash & short-term investment	109,671	48,585	57,716	36,816	79,799
Global	67,761	83,187	76,363	90,546	101,743	Inventory	5,427	5,446	5,240	5,681	6,237
Others	(18,933)	(34,619)	(38,796)	(48,570)	(51,952)	Accounts receivable	39,618	33,117	36,898	36,927	40,535
Total revenue	222,505	214,964	207,195	224,636	246,588	Other current assets	85,271	74,825	74,875	80,537	85,941
Other income	0	0	0	0	0	Total current assets	239,987	161,972	174,730	159,961	212,511
COGS	(79,845)	(92,783)	(94,261)	(102,454)	(110,360)	Fixed assets	727,053	712,539	703,987	690,928	676,952
SG&A	(38,599)	(35,328)	(33,151)	(35,942)	(39,454)	Goodwill & intangibles	52,215	49,976	140,026	140,026	140,026
Other op. expenses	(52,805)	(52,466)	(54,332)	(60,679)	(17,788)	Other non-current assets	2,815	1,200	1,200	1,200	1,200
EBIT	51,257	34,387	25,452	25,562	32,953	Total assets	1,022,070	925,686	1,019,943	992,114	1,030,688
Net-interest inc./(exp.)	(9,725)	(12,491)	(8,693)	(8,149)	(6,426)	Short-term debt	118,716	80,634	0	0	0
Assoc/forex/extraord./others	20,451	30,306	(1,542)	0	0	Accounts payable	46,471	40,899	45,413	49,235	54,047
Pre-tax profit	61,983	52,202	15,217	17,413	26,527	Other current liabilities	154,343	146,453	141,160	153,043	167,998
Tax	518	(4,454)	(906)	(2,090)	(5,305)	Total current liabilities	319,530	267,985	186,573	202,278	222,044
Min. int./pref. div./others	(2,052)	(1,193)	(598)	(662)	(782)	Long-term debt	272,906	216,520	377,154	320,592	320,592
Net profit (reported)	60,449	46,556	13,713	14,662	20,440	Other non-current liabilities	281	991	991	991	991
Net profit (adj.)	60,524	20,480	13,713	14,662	20,440	Total liabilities	592,718	485,496	564,718	523,860	543,627
EPS (reported) (Rs)	29.287	22.556	6.644	7.103	9.903	Share capital	10,320	10,320	10,320	10,320	10,320
EPS (adj.) (Rs)	29.323	9.923	6.644	7.103	9.903	Reserves/R.E./others	412,483	423,286	437,723	450,091	468,116
DPS (Rs)	0.800	0.850	0.900	0.950	1.000	Shareholders' equity	422,803	433,607	448,043	460,411	478,436
EBIT (adj.)	51,257	34,387	25,452	25,562	32,953	Minority interests	6,549	6,584	7,182	7,844	8,625
EBITDA (adj.)	87,334	71,852	65,083	70,070	78,986	Total equity & liabilities	1,022,070	925,686	1,019,943	992,114	1,030,688
						Net debt/(cash)	281,951	248,569	319,438	283,775	240,793

Cash flow (Rs m)					
Year to 31 Mar	2009	2010	2011E	2012E	2013E
Profit before tax	61,967	52,234	15,222	17,413	26,527
Depreciation and amortisation	36,077	37,465	39,631	44,508	46,033
Tax paid	(3,926)	(3,122)	(3,044)	(3,483)	(5,305)
Change in working capital	(21,519)	25,293	(1,006)	7,719	6,143
Other operational CF items	(7,524)	(16,226)	10,197	11,276	10,362
Cash flow from operations	65,075	95,645	61,000	77,434	83,759
Capex	(122,426)	(74,959)	(121,129)	(31,449)	(32,056)
Net (acquisitions)/disposal	15,567	54,884	40,399	0	0
Other investing CF items	6,779	1,689	0	0	0
Cash flow from investing	(100,079)	(18,387)	(80,730)	(31,449)	(32,056)
Change in debt	75,084	(69,898)	80,000	(56,563)	0
Net share issues/(repurchases)	0	0	0	0	0
Dividends paid	(1,792)	(1,911)	(2,046)	(2,173)	(2,294)
Other financing CF items	(30,861)	(14,408)	(8,693)	(8,149)	(6,426)
Cash flow from financing	42,431	(86,217)	69,261	(66,885)	(8,720)
Forex effect/others	620	316	0	0	0
Change in cash	8,047	(8,644)	49,531	(20,900)	42,982

Key assumptions					
Year to 31 Mar	2009	2010	2011E	2012E	2013E
Total mobile subs (m)	72.67	102.42	129.38	154.27	177.91
Subscriber net add (m)	26.87	29.76	26.96	24.89	23.64
Total usage (bn min)	276,700	350,324	398,872	497,846	588,850
MOU per sub (min)	389	333	287	293	295
Blended ARPU (Local curr.)	244.4	158.4	122.0	107.3	98.7
Data as % of total ARPU	7.3%	7.7%	8.0%	9.0%	10.0%

Key ratios					
Year to 31 Mar	2009	2010	2011E	2012E	2013E
Sales – YoY %	18.2	(3.4)	(3.6)	8.4	9.8
EBITDA (adj.) – YoY %	9.5	(17.7)	(9.4)	7.7	12.7
Net profit (adj.) – YoY %	46.4	(66.2)	(33.0)	6.9	39.4
EPS (adj.) – YoY %	45.7	(66.2)	(33.0)	6.9	39.4
EBITDA margin % (adj.)	39.3	33.4	31.4	31.2	32.0
EBIT margin % (adj.)	23.0	16.0	12.3	11.4	13.4
Net-profit margin % (adj.)	27.2	9.5	6.6	6.5	8.3
ROAE (%)	17.0	4.8	3.1	3.2	4.4
ROAA (%)	6.7	2.1	1.4	1.5	2.0
ROCE (%)	7.4	4.4	3.2	3.2	4.1
ROIC (%)	8.8	4.5	3.3	2.9	3.6
Net debt to equity (%)	66.7	57.3	71.3	61.6	50.3
Effective tax rate (%)	n.a.	8.5	6.0	12.0	20.0
Accounts receivable (days)	54.8	61.8	61.7	60.0	57.3
Payables (days)	109.4	74.2	76.0	76.9	76.4
Net interest cover (x)	5.3	2.8	2.9	3.1	5.1
Net dividend payout (%)	2.7	3.8	13.5	13.4	10.1



Source: Company, Daiwa forecasts

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