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UPDATE

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**3G auction process gets rolling again.** The Department of Telecommunications has released NIA (notice inviting applications) for 3G auctions. Auction process for 3G spectrum is slated to start on April 9, 2010 and BWA spectrum auction starts 2 days after the close of 3G auction. With 3 slots in 17 circles and 4 slots in 5 circles for 3G available for auction, and at least 6 serious operators (in our view) vying for a piece of India 3G story, we expect aggressive bidding and would not be surprised if pan-India 3G spectrum auction clears at > US\$2 bn. Cautious view stays.

#### Limited number of slots for 3G spectrum may push bids higher

Exhibit 1 depicts the number of 3G slots being auctioned to private players (excluding the one slot reserved for, and already allotted to, BSNL/MTNL in every circle). With 3 slots being auctioned in 17/22 circles and 4 in the other 5, and at least 6 serious operators (in our view) vying for a pan-India or large 3G presence, we believe that the bidding could get aggressive. The DoT has set a reserve price of Rs3.2 bn for Delhi, Mumbai and Category A circles, Rs1.2 bn for Category B circles, and Rs0.3 bn for Category C circles, totaling to a pan-India reserve price of Rs35 bn (or US\$760 mn). We would not be surprised if the sum of winning bids across the 22 circles crosses US\$2 bn.

#### Aggressive bids likely, Government the only winner in the near term

We believe that aggressive bids for 3G spectrum will be driven more by the potential downside of not having 3G spectrum (while some of your competitors have it) rather than based on a standalone 3G business case. Amid all the price competition in the Indian wireless market, protecting the low-churn, high-value customer segment (also the 3G-ready customer segment, broadly speaking) is imperative, especially for the incumbent service providers in the country. We discuss the potential impact of 3G auction fee + capex on the financials of the listed telecom players in the country, later in the note. We expect near-term earnings dilution for the winners.

#### 3G/BWA spectrum auction—key aspects and revised timeline

- ▶ Exhibit 2 depicts the revised timeline for the auction process. NIA has already been released by the DoT; operators need to submit their applications by March 19, 2010 while auctions are slated to start on April 9, 2010. BWA spectrum auction will start 2 days after the close of 3G auction. Operators can not roll out commercial operations before September 1, 2010.
- ▶ 3G spectrum—3 blocks to be auctioned in 17 circles, and 4 in the other 5; 2 blocks of BWA spectrum to be auctioned across all the 22 circles.
- ▶ The 3G as well as BWA auction process would be simultaneous ascending e-auction with two stages—(1) the clock stage, which would determine the winning price and winning bidders (of generic slots) in various circles, and (2) the frequency identification stage, where the winning bidders will be assigned frequencies on a random basis. Without getting into the technical details here, we highlight that the auction process is designed to prevent irrational bidding.
- ▶ New players will not be automatically awarded a UAS or ISP license on winning 3G/BWA spectrum bid. The NIA also mentions that the DoT may revise UAS license conditions and that such new players will not be guaranteed start-up 2G spectrum, though they need to shell out UAS license fee of ~US\$350 mn. We see these conditions as deterrents for new players.

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Exhibit 1: 3G WCDMA (GSM, 2.1GHz band) spectrum availability in various circles

	Reserve price for 3G spectrum (Rs mn)	2X5 MHz blocks available (#)	Blocks allotted to MTNL/BSNL (#)	Blocks available for auction to private players (#)
<b>Metro</b>				
Calcutta	1,200	4	1	3
Chennai	Clubbed with Tamil Nadu			
<b>Delhi</b>	<b>3,200</b>	<b>4</b>	<b>1</b>	<b>3</b>
Mumbai	3,200	4	1	3
<b>Circle A</b>				
Andhra Pradesh	3,200	4	1	3
Gujarat	3,200	4	1	3
Karnataka	3,200	4	1	3
Maharashtra	3,200	4	1	3
Tamil Nadu	3,200	4	1	3
<b>Circle B</b>				
Haryana	1,200	4	1	3
Kerala	1,200	4	1	3
Madhya Pradesh	1,200	4	1	3
Punjab	1,200	5	1	4
Rajasthan	1,200	4	1	3
Uttar Pradesh (east)	1,200	4	1	3
Uttar Pradesh (west)	1,200	4	1	3
West Bengal	1,200	5	1	4
<b>Circle C</b>				
Assam	300	4	1	3
Bihar	300	5	1	4
Himachal Pradesh	300	5	1	4
North East	300	4	1	3
Orissa	300	4	1	3
J&K	300	5	1	4
<b>Pan-India</b>	<b>35,000</b>			

Source: DOT

Exhibit 2: Indicative timeline of the 3G/BWA auction process

Process	Timeline
Notice Inviting applications	25-Feb-10
Final date for submission of applications	19-Mar-10
Publication of ownership details of applicants	23-Mar-10
Bidder ownership compliance certificate	26-Mar-10
Pre-qualification of bidders	30-Mar-10
Mock auction	05/06-Apr-10
<b>Start of the 3G auction</b>	<b>9-Apr-10</b>
Start of the BWA auction	2 days from the day of close of the 3G auction
Payment of the successful bid amount	Within 10 calendar days of close of relevant auction

Source: DOT

### 2G + 3G operators to pay 1% additional spectrum charge on total AGR; Bharti to get impacted the most

Exhibit 3 depicts the spectrum usage charges applicable to the successful 3G bidders. Key highlights—

- ▶ The 2G + 3G operators would pay spectrum usage charges on total 2G + 3G adjusted gross revenues. Standalone 3G operators would attract the bottom slab rates, i.e. 3% of AGR.

- ▶ Proposed spectrum usage charges are higher than the current slabs applicable to 2G operators (also depicted in Exhibit 3)—this would mean increased incidence of regulatory levy on the existing base of revenues as well, especially in circles where a winning operator holds spectrum of more than 8.2 MHz. Bharti will get impacted in seven circles.
- ▶ BWA spectrum would attract a spectrum charge equal to 1% of AGR from BWA services.
- ▶ 3G/BWA spectrum assigned in the auction will not to be counted towards calculation of spectrum charge slab.
- ▶ Annual spectrum charges shall be applicable from the date of award of right to use allotted spectrum commercially (September 1, 2010). However, there shall be a moratorium of one year from this date on the payment of spectrum charges for the standalone 3G as well as standalone 3G + BWA operators (i.e. winners of 3G/ BWA Spectrum who do not hold 2G spectrum). The moratorium of one year shall not be applicable to operators holding 2G + 3G Spectrum.

Exhibit 3: Spectrum usage charges for 3G operators

Spectrum usage charges applicable to existing 2G operators					
GSM Operators			CDMA operators		
Spectrum (upto)	Existing charges	2G+3G	Spectrum (upto)	2G+3G	
MHz	% of AGR	% of AGR	MHz	% of AGR	
4.4	2	3	5.00	3	
6.2	3	4	6.25	4	
<b>8.2</b>	<b>4</b>	<b>5</b>	<b>7.50</b>	<b>5</b>	
<b>10.2</b>	<b>4</b>	<b>6</b>	<b>10.00</b>	<b>6</b>	
<b>12.2</b>	<b>5</b>	<b>7</b>	<b>12.50</b>	<b>7</b>	
<b>15.2</b>	<b>5</b>	<b>8</b>	<b>15.00</b>	<b>8</b>	
Spectrum usage charges applicable to BWA Licensees					% of AGR
					<b>1</b>

Source: DOT

### 3G will lead to earnings dilution for successful bidders in the near term

We highlight that the successful bidders will see an earnings dilution in the near term on account of (1) amortization of spectrum price—the payment made for 3G spectrum will be amortized over 20 years (US\$100 mn per annum assuming a pan-India clearing price of US\$ 2 bn), (2) increased spectrum usage charges on 2G + 3G AGR—we emphasize that the upward revision in spectrum charge slab will be applicable to 2G AGR as well, and (3) increased depreciation and interest cost without commensurate EBITDA from 3G rollout in initial years of rollout. Some of these earnings-dilutive factors will likely be mitigated in the later years as 3G services start generating revenues/EBITDA, and capex intensity of the business goes down (3G as a technology entails lower capacity capex as compared to 2G). Further, we also highlight that there would be no tax benefits on 3G auction fee and rollout capex under Sec 80 IA of the Income Tax Act.

### Valuing 3G spectrum is a challenge

We believe that the value for 3G spectrum would be operator specific (whether existing or new) and depend on the extent of congestion in extant 2G networks (for incumbents). As indicated earlier, we believe that at least in the initial phase, 3G spectrum would be used to augment 2G voice capacity (especially in metros) rather than high data usage. Further, we expect 3G services to be viable (for the time being) only in select large cities and metro circles.

For an existing operator in circles with choked 2G networks, the value of 3G spectrum would be determined by multiple factors (1) value of capex savings from using 3G spectrum for voice versus deploying expensive microcells, picocells, etc. to augment 2G voice capacity, (2) number of blocks of spectrum available for auction in each circle and (3) potential incremental revenues from 3G services such as high-speed data and other VAS. This in our view will be adjusted for factors such as higher capex per sub (2-2.5X assuming allocation of spectrum in 900 MHz band) and higher spectral efficiency (1.5X the number of minutes as compared to 2G in 900 MHz band). For operators that have limited congestion in the 2G networks, value for 3G spectrum would largely be a function of NPV of incremental revenues minus the capex, spectrum costs and meeting mandatory roll out obligations.

Given these variables, valuing spectrum is a challenge though it is reasonable to assume that bidding would be aggressive in Metros and a few category A circles.

### Aggressive bids could stretch the balance sheets of wireless operators

We discuss the implications of the 3G auctions on the financials of each of the wireless companies. We assume/ value pan-India 3G license at US\$2 bn.

- ▶ Bharti Airtel—3G auctions alone would not strain Bharti's balance sheet but it would be stretched (although the least among the listed players) if the Zain acquisition goes through and is 100% debt funded. Bharti has a strong balance sheet with FY2010E net debt/EBITDA ratio of 0.1X and debt/equity ratio of 0.20X. Assuming pan-India 3G license of US\$2 bn and capex of US\$300 mn in FY2011E and further capex of US\$700 mn in FY2012E, its net debt/EBITDA ratio may change to 0.8X and 0.6X for FY2011E and FY2012E, respectively. Further, if the Zain acquisition goes through and Bharti funds it entirely by debt, the net debt/EBITDA ratio would stretch to 3.1X in FY2011E and 2.7X in FY2012E.

Exhibit 4: Assessing impact of Zain acquisition and 3G auction on Bharti's debt position

	FY2009	FY2010E	FY2011E	FY2012E
Gross Debt	118,801	79,151	50,396	-
Cash and cash equivalents	49,070	42,343	39,267	29,055
Net Debt	69,731	36,808	11,129	(29,055)
EBITDA	151,563	160,410	151,686	173,119
<b>Current net debt/TTM EBITDA (X)</b>			<b>0.1</b>	<b>(0.2)</b>
3G license fees + year 1 capex			105,800	32,200
<b>Net debt/EBITDA (X)</b>			<b>0.8</b>	<b>0.6</b>
<b>Acquisition impact</b>				
Incremental funding requirements			26,680	25,116
Incremental EBITDA			55,200	64,400
<b>Pro-forma combined entity</b>				
Net Debt			635,809	652,941
EBITDA			206,886	237,519
<b>Net debt/EBITDA (X)</b>			<b>3.1</b>	<b>2.7</b>

Note:

(a) Assuming US\$2 bn pan-India license fees + US\$300 mn of capex in FY2011E and further US\$700 mn capex in FY2012E.

Source: Company, Kotak Institutional Equities estimates

- ▶ RCOM—stretched balance sheet. We believe that the RCOM is constrained to fund even its planned 2G network expansion. 3G auctions and subsequent capex may pressure the financials further. Exhibit 5 details the debt/ EBITDA ratio assuming pan-India 3G license of US\$2 bn and capex of US\$300 mn in FY2011E and further capex of US\$700 mn in FY2012E. We highlight that the FY2011E net debt/EBITDA ratio of RCOM jumps to 4.9X from the current estimated 3.4X and to 3.9X from 1.6X for FY2012E, factoring in the 3G license fees and capex estimates.

Exhibit 5: Assessing impact of 3G auction on RCOM's debt position

(Rs mn)	FY2009	FY2010E	FY2011E	FY2012E
Gross debt	391,623	411,623	386,623	304,075
Cash and equivalents	112,486	146,721	145,458	160,884
Net debt	279,137	264,902	241,165	143,192
EBITDA	92,976	77,478	71,290	90,820
<b>Net debt/TTM EBITDA (X) (a)</b>	<b>3.0</b>	<b>3.4</b>	<b>3.4</b>	<b>1.6</b>
3G license fees + year 1 capex			105,800	32,200
<b>Net debt/TTM EBITDA (X) (b)</b>		<b>3.4</b>	<b>4.9</b>	<b>3.1</b>

Note:

(a) Current, without factoring in 3G.

(b) Assuming US\$2 bn pan-India license fees + US\$300 mn of capex in FY2011E and further US\$700 mn capex in FY2012E.

Source: Kotak Institutional Equities

- ▶ Idea Cellular—can fund 2G capex but may need equity in case it intends to get 3G license on pan-India basis. Idea is comfortably placed for fund 2G expansion though its balance sheet would get stretched due to 3G auctions. Based on the current 2G active infrastructure capex, we estimate net debt to EBITDA at 2.2X at end-FY2011E. End-FY2011E net-debt to EBITDA may expand to 5.5X in case of 3G auction (assuming that it bids for pan-India license and funds the entire 3G investment by debt) and license payment (assuming US\$2 bn the total license fee outlay) and 5.7X for FY2012E (see Exhibit 6). 3G capex and expansion, in addition to investment in new circles, may increase the operating and financial leverage further which is not a good attribute in an increasingly competitive market. **We believe that the company may not bid for pan-India 3G license.**

Exhibit 6: Assessing impact of 3G auction on Idea's debt position

(Rs mn)	FY2009	FY2010E	FY2011E	FY2012E
Gross debt	89,165	86,165	103,665	116,165
Cash and equivalents	51,316	29,702	30,536	28,496
Net debt	37,849	56,462	73,129	87,669
EBITDA	28,353	32,253	32,511	39,367
<b>Net debt/TTM EBITDA (X) (a)</b>	<b>1.3</b>	<b>1.8</b>	<b>2.2</b>	<b>2.2</b>
3G license fees + year 1 capex			105,800	32,200
<b>Net debt/TTM EBITDA (X) (b)</b>			<b>5.5</b>	<b>5.7</b>

Note:

(a) Current, without factoring in 3G.

(b) Assuming US\$2 bn pan-India license fees + US\$300 mn of capex in FY2011E and further US\$700 mn of capex in FY2012E. Idea may choose not to bid for a pan-India 3G license, in our view.

Source: Company, Kotak Institutional Equities estimates

### Guidelines on auction of BWA spectrum auction

The Government would auction two blocks of unpaired spectrum out of the available four in all the 22 circles in the 2.3GHz and 2.5GHz band. DOT has reserved 1 block in the 2.6 GHz band for MTNL/BSNL for WIMAX operations. Exhibit 7 gives the reserve price and spectrum available in the 22 circles. The reserve price for a pan-India spectrum allocation is Rs17.5 bn. The auction rules for BWA are largely on the lines of 3G auctions and would take place two days after closure of 3G spectrum auction. Licensees using BWA spectrum need to pay 1% of AGR from BWA services (revenues from BWA services to be reported separately) irrespective of the license held by them. BWA operators would have to pay spectrum charges from the 2<sup>nd</sup> year of spectrum allocation (moratorium in the first year).

Exhibit 7: BWA spectrum (in 2.3 GHz band) availability in various circles

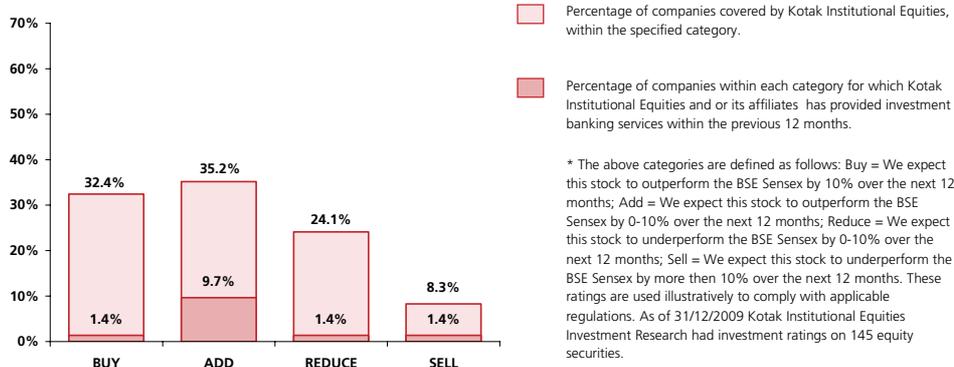
	Reserve price for BWA spectrum (Rs mn)	No of blocks of 20 MHz available	Blocks allotted to MTNL/BSNL	Blocks available for private players
<b>Metro</b>				
Calcutta	600	3	1	2
Chennai		Clubbed with Tamil Nadu		
Delhi	1,600	3	1	2
Mumbai	1,600	3	1	2
<b>Circle A</b>				
Andhra Pradesh	1,600	3	1	2
Gujarat	1,600	3	1	2
Karnataka	1,600	3	1	2
Maharashtra	1,600	3	1	2
Tamil Nadu	1,600	3	1	2
<b>Circle B</b>				
Haryana	600	3	1	2
Kerala	600	3	1	2
Madhya Pradesh	600	3	1	2
Punjab	600	3	1	2
Rajasthan	600	3	1	2
Uttar Pradesh (east)	600	3	1	2
Uttar Pradesh (west)	600	3	1	2
West Bengal	600	3	1	2
<b>Circle C</b>				
Assam	150	3	1	2
Bihar	150	3	1	2
Himachal Pradesh	150	3	1	2
North East	150	3	1	2
Orissa	150	3	1	2
J&K	150	3	1	2
<b>Pan-India</b>	<b>17,500</b>			

Source: DOT

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