

# RELIANCE COMMUNICATIONS

Execution is the key



## Key takeaways from our meeting with the management of Reliance Communications (RCOM):

### ■ GSM operations update

GSM network coverage is almost at par with that of CDMA. Management indicated that post the phase-out of initial GSM promotional schemes, customers are increasing usage and recharging beyond the free minutes. ARPU is thus gradually normalizing; further scale-up in usage is expected over the next few quarters.

### ■ Competitive intensity manageable

Entry of new operators is unlikely to be disruptive. Tariffs are already competitive and have ceased to be a differentiator to attract customers. New operators also lack the scale of marketing & distribution and brand presence enjoyed by incumbents, which is a material drawback. Management indicated that Reliance Infratel is currently in negotiations for tie-ups with new operators for tower-sharing.

### ■ 3G: Entry price is key

Incremental capex for 3G is not expected to be substantial since it will be an overlay on the existing 2G infrastructure; management indicated most cell sites are 3G ready. 3G is expected to provide a fillip to VAS, which could help to stabilise/improve ARPU over the long term.

### ■ MNP impact expected to be positive

Introduction of MNP is expected to be positive for GSM operations; management does not expect any material increase in its CDMA subscribers' churn rates. Management is confident of maintaining/improving the wireless market share post-MNP, and being an integrated operator expects to have a competitive edge over pure wireless operators.

### ■ Outlook and valuations: Recommend 'HOLD'

We remain cautious on the stock, given subdued earnings expectations over FY10-11E, execution risks on the GSM launch and high debt levels. Irrational bidding for 3G license remains a risk. At INR 270, the stock is trading at an EV/EBITDA of 7.1x FY10E and 6.4x FY11E, and P/E of 12.5x FY10E and 12.3x FY11E. We recommend 'HOLD'.

July 20, 2009

Reuters : RLCM.BO Bloomberg : RCOM IN

#### EDELWEISS 4D RATINGS

Absolute Rating	HOLD
Rating Relative to Sector	Performer
Risk Rating Relative to Sector	Medium
Sector Relative to Market	Overweight

Note:  
Please refer last page of the report for rating explanation

#### MARKET DATA

CMP	:	INR 270
52-week range (INR)	:	541 / 131
Share in issue (mn)	:	2,064.0
M cap (INR bn/USD mn)	:	557 / 11,443
Avg. Daily Vol. BSE ('000)	:	9,361.8

#### SHARE HOLDING PATTERN (%)

Promoters*	:	67.3
MFs, FIs & Banks	:	9.2
FIIIs	:	9.3
Others	:	14.2
* Promoters pledged shares (% of share in issue)	:	13.2

#### RELATIVE PERFORMANCE (%)

	Sensex	Stock	Stock over Sensex
1 month	3.4	(8.6)	(11.9)
3 months	34.3	25.2	(9.1)
12 months	8.1	(38.8)	(47.0)

## Financials

Year to March	FY08	FY09	FY10E	FY11E
Net revenues (INR mn)	190,672	229,411	275,322	307,892
Rev. growth (%)	31.8	20.3	20.0	11.8
EBIDTA (INR mn)	81,989	92,874	106,343	118,262
Adj. net profit (INR mn)	54,010	59,152	46,630	47,369
Diluted EPS (INR)	26.2	27.4	21.6	22.0
Y-o-Y growth (%)	67.5	4.8	(21.2)	1.6
P/E (x)	10.3	9.8	12.5	12.3
EV/ EBITDA	9.3	8.2	7.1	6.4
ROAE (%)	21.1	18.0	11.8	10.7

#### ■ GSM operations update

- GSM coverage is almost at par with CDMA coverage – currently, RCOM is offering GSM services in ~22k towns and ~400k villages (CDMA presence in ~23k towns and ~500k villages)
- Management indicated that post the phase-out of initial promotional schemes, customers are increasing usage and recharging beyond the free minutes. ARPU is thus gradually normalizing; further scale-up in usage is expected over the next few quarters.
- Overall ARPU is expected to downtrend with greater rural penetration and competition. 3G is expected to drive growth of VAS and over the long term, uptake of VAS could help to stabilise or even improve ARPU.

#### ■ Competitive intensity manageable

- Entry of new operators is unlikely to be disruptive. Tariffs are already competitive and have ceased to be a differentiator to attract customers. New operators also lack the scale of marketing & distribution and brand presence enjoyed by incumbents, which is a material drawback.
- New operators, however, will enjoy speedier rollouts through passive infrastructure sharing; management expects this to be beneficial for its towerco, Reliance Infratel, and is currently in negotiations for tie-ups with new operators. Reliance Infratel had a tower portfolio of ~48k towers in March 2009.

#### ■ 3G: Entry price is key

- Incremental capex for 3G is not expected to be substantial since it will be an overlay on the existing 2G infrastructure; management indicated most cell sites are 3G ready. We understand, the auction price will, therefore, be the key to determining returns; the risk of over-bidding remains in the metro/tier 1 locations, if spectrum availability is limited.
- 3G is expected to provide a fillip to VAS, which could help to stabilise/improve ARPU over the long term.

#### ■ MNP impact expected to be positive

- Introduction of MNP is expected to be positive for GSM operations; management is confident of maintaining/improving the wireless market share post-MNP, and does not expect any material increase in churn rates for its CDMA subscriber base.
- Being an integrated operator, the company expects to have a competitive edge over pure wireless operators, by offering integrated packages particularly to enterprise customers.

- **Company Description**

RCOM is the flagship company of the Reliance-ADA Group. Incorporated in July 2004, RCOM is India's leading integrated telecom, providing the entire gamut of telecom services including wireless, wireline, broadband, carrier and data services. The company commenced cellular operations in December 2002, and is India's second largest wireless operator. RCOM offers pan-India CDMA- and GSM-based wireless services. It also enjoys a strong position in the long distance and broadband segments. It operates undersea cable systems through FLAG and FALCON, connecting over 40 countries. The company has hived off its passive infrastructure into a separate subsidiary called Reliance Infratel; the subsidiary had a tower portfolio of ~48k in March 2009.

- **Investment Theme**

With a pan-India wireless network and an integrated business model, we believe RCOM offer investors a unique mix of voice and data business streams with an opportunity to play the India and global telecom growth stories. Despite relatively inexpensive valuations, we remain cautious on the stock on account of subdued earnings expectations over FY10-11E, high debt levels and execution risks on the recently launched GSM services.

- **Key Risks**

Regulatory shocks are key concerns for the overall sector. Besides, competitive pressures driving down mobility tariffs to below estimated levels could lead to downsides to our revenue and profitability estimates. Lower-than-expected volume growth or higher-than anticipated pressures on realisation rates on the non-mobility business could negatively impact margins, leading to lower-than-estimated profitability.

## Financial Statements

Income statement					(INR mn)
Year to March	FY07	FY08	FY09	FY10E	FY11E
Gross revenues	174,360	229,053	276,779	329,354	367,806
Inter segment	29,677	38,380	47,368	54,033	59,913
Net revenues	144,683	190,672	229,411	275,322	307,892
Direct costs	54,560	62,590	79,407	96,035	107,441
Employee costs	9,080	12,037	16,702	19,938	22,929
Other expenses	23,832	34,055	40,428	53,004	59,261
Total operating expenses	87,472	108,683	136,537	168,978	189,630
EBITDA	57,211	81,989	92,874	106,343	118,262
Depreciation and amortisation	24,653	28,053	39,313	47,201	57,853
EBIT	32,558	53,936	53,561	59,143	60,409
Interest expenses	7	(3,998)	(7,867)	8,065	8,522
Profit before tax	32,551	57,934	61,428	51,078	51,887
Provision for tax	610	2,836	(123)	2,554	2,594
Core profit	31,942	55,098	61,551	48,524	49,293
Extraordinary items	(303)	12,828	(75)	0	0
Profit after tax	31,639	67,926	61,476	48,524	49,293
Minority interest	-	1,088	2,399	1,894	1,924
Profit after minority interest	31,639	66,838	59,077	46,630	47,369
Interest on FCCB	0	0	1,910	2,046	1,985
Adl profit after minority interest	31,639	66,838	57,167	44,585	45,385
Equity shares outstanding (mn)	2,045	2,064	2,157	2,157	2,157
EPS (INR) basic	15.6	26.2	27.4	21.6	22.0
Diluted shares (mn)	2,045	2,064	2,157	2,157	2,157
EPS (INR) fully diluted	15.6	26.2	27.4	21.6	22.0
Adjusted EPS (INR) fully diluted	15.5	32.4	26.5	20.7	21.0
CEPS (INR)	27.7	39.8	45.6	43.5	48.8
Dividend per share	0.5	0.8	1.0	1.0	1.0
Dividend payout (%)	3.2	3.4	4.3	5.4	5.3

### Common size metrics- as % of net revenues

Year to March	FY07	FY08	FY09	FY10E	FY11E
Operating expenses	60.5	57.0	59.5	61.4	61.6
Depreciation	17.0	14.7	17.1	17.1	18.8
Interest expenditure	0.0	(2.1)	(3.4)	2.9	2.8
EBITDA margins	39.5	43.0	40.5	38.6	38.4
Net profit margins	22.1	28.9	26.8	17.6	16.0

### Growth metrics (%)

Year to March	FY07	FY08	FY09	FY10E	FY11E
Revenues	34.4	31.8	20.3	20.0	11.8
EBITDA	125.7	43.3	13.3	14.5	11.2
PBT	531.8	78.0	6.0	(16.8)	1.6
Net profit	563.5	72.5	11.7	(21.2)	1.6
EPS	563.5	67.5	4.8	(21.2)	1.6

**Balance sheet**
**(INR mn)**

As on 31st March	FY07	FY08	FY09E	FY10E	FY11E
Equity capital	10,223	10,320	10,787	10,787	10,787
Reserves & surplus	219,083	272,695	361,972	407,972	454,741
Shareholders funds	229,306	283,015	372,759	418,759	465,528
Minority Interest	56	24,311	24,311	24,311	24,311
Secured loans	51,136	9,500	0	0	0
Unsecured loans	123,248	206,181	274,899	278,969	198,105
Borrowings	174,384	215,681	274,899	278,969	198,105
<b>Sources of funds</b>	<b>403,746</b>	<b>523,007</b>	<b>671,969</b>	<b>722,039</b>	<b>687,943</b>
Gross block	349,442	463,640	611,065	868,756	1,001,242
Accumulated depreciation	55,926	89,814	129,127	176,328	234,181
Net block	293,516	373,826	481,938	692,428	767,061
Capital work in progress	36,907	148,327	191,000	63,667	31,833
Total fixed assets	330,423	522,153	672,938	756,095	798,894
Goodwill	26,588	26,588	26,588	26,588	26,588
Investments	-	2,797	2,818	2,818	2,818
Inventories	4,821	4,059	4,743	5,016	5,012
Sundry debtors	18,316	27,224	48,275	54,420	59,242
Cash and equivalents	149,120	115,981	118,538	99,145	40,178
Loans and advances	22,103	42,834	64,911	75,950	81,469
Other current assets	13,884	23,058	38,294	53,530	68,765
Total current assets	208,244	213,156	274,760	288,060	254,667
Sundry creditors and others	114,334	199,267	261,609	303,415	345,863
Provisions	47,149	42,420	43,650	48,231	49,285
Total CL & provisions	161,483	241,687	305,258	351,646	395,148
Net current assets	46,762	(28,531)	(30,498)	(63,586)	(140,481)
Net deferred tax	(26)	0	123	123	123
<b>Uses of funds</b>	<b>403,746</b>	<b>523,007</b>	<b>671,969</b>	<b>722,039</b>	<b>687,943</b>
Book value per share (BV) (INR)	72	121	157	179	200

**Free cash flow**
**(INR mn)**

Year to March	FY07	FY08	FY09E	FY10E	FY11E
Net profit	31,639	66,838	57,167	44,585	47,369
Depreciation	24,653	28,053	39,313	47,201	57,853
Others	(1)	1,087	2,398	1,893	(62)
Gross cash flow	56,291	95,978	98,878	93,678	105,160
Less: Changes in WC	(48,800)	(42,153)	(4,524)	(13,695)	(17,929)
Operating cash flow	105,091	138,132	103,402	107,373	123,089
Less: Capex	126,749	225,618	190,098	130,357	100,653
<b>Free cash flow</b>	<b>(21,658)</b>	<b>(87,486)</b>	<b>(86,696)</b>	<b>(22,985)</b>	<b>22,436</b>

**Cash flow metrices**

Year to March	FY07	FY08	FY09E	FY10E	FY11E
Operating cash flow	105,091	138,132	103,402	107,373	123,089
Financing cash flow	71,051	41,396	59,686	4,071	(80,863)
Investing cash flow	126,749	228,415	190,119	130,357	100,653
Net cash flow	49,393	(48,888)	(27,032)	(18,914)	(58,427)
Capex	(126,749)	(225,618)	(190,098)	(130,357)	(100,653)
Dividends paid	(1,022)	(1,811)	(2,524)	(2,524)	(2,524)

**Profitability & liquidity ratios**

Year to March	FY07	FY08	FY09E	FY10E	FY11E
ROAE (%)	18.4	21.1	18.0	11.8	10.7
ROACE (%)	10.4	11.7	9.0	8.5	8.6
Current ratio	1.3	0.9	0.9	0.8	0.6
Debtors (days)	44	44	60	68	67
Fixed assets t/o (x)	0.5	0.4	0.4	0.4	0.4
Average working capital t/o (x)	5.4	20.9	(7.8)	(5.9)	(3.0)
Debt/Equity	0.8	0.8	0.7	0.7	0.4
Debt/EBITDA	3.0	2.6	3.0	2.6	1.7
Adjusted debt/Equity	0.8	0.8	0.7	0.7	0.4

**Operating ratios**

Year to March	FY07	FY08	FY09E	FY10E	FY11E
Total asset turnover	0.5	0.4	0.4	0.4	0.4
Fixed asset turnover	0.6	0.6	0.5	0.5	0.4
Equity turnover	0.8	0.7	0.7	0.7	0.7

**Du pont analysis**

Year to March	FY07	FY08	FY09E	FY10E	FY11E
NP margin (%)	22.1	28.3	25.8	16.9	15.4
Total assetstTurnover	0.5	0.4	0.4	0.4	0.4
Leverage multiplier	1.8	1.8	1.8	1.8	1.6
ROE (%)	18.4	21.1	18.0	11.8	10.7

**Valuation parameters**

Year to March	FY07	FY08	FY09E	FY10E	FY11E
Diluted EPS (INR)	15.6	26.2	27.4	21.6	22.0
Y-o-Y growth	563.5	67.5	4.8	(21.2)	1.6
CEPS (INR)	27.7	39.8	45.6	43.5	48.8
Diluted P/E (x)	17.3	10.3	9.8	12.5	12.3
Adjusted P/E (x)	17.4	8.3	10.2	13.1	12.8
Price/BV(x)	3.7	2.2	1.7	1.5	1.3
EV/Sales (x)	4.0	3.6	3.3	2.8	2.5
EV/EBITDA (x)	13.3	9.3	8.2	7.1	6.4
Dividend yield (%)	0.2	0.3	0.4	0.4	0.4

Company	Absolute reco	Relative reco	Relative risk
Tulip Telecom	Buy	SO	H
Bharti Airtel	Buy	SP	L
Reliance Communications	Hold	SP	M
Mahanagar Telephone Nigam	Reduce	SU	M

## ABSOLUTE RATING

Ratings	Expected absolute returns over 12 months
Buy	More than 15%
Hold	Between 15% and - 5%
Reduce	Less than -5%

## RELATIVE RETURNS RATING

Ratings	Criteria
Sector Outperformer (SO)	Stock return > 1.25 x Sector return
Sector Performer (SP)	Stock return > 0.75 x Sector return
	Stock return < 1.25 x Sector return
Sector Underperformer (SU)	Stock return < 0.75 x Sector return

Sector return is market cap weighted average return for the coverage universe within the sector

## RELATIVE RISK RATING

Ratings	Criteria
Low (L)	Bottom 1/3rd percentile in the sector
Medium (M)	Middle 1/3rd percentile in the sector
High (H)	Top 1/3rd percentile in the sector

Risk ratings are based on Edelweiss risk model

## SECTOR RATING

Ratings	Criteria
Overweight (OW)	Sector return > 1.25 x Nifty return
Equalweight (EW)	Sector return > 0.75 x Nifty return
	Sector return < 1.25 x Nifty return
Underweight (UW)	Sector return < 0.75 x Nifty return

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### Coverage group(s) of stocks by primary analyst(s): Telecom

Bharti Airtel, Mahanagar Telephone Nigam, Reliance Communications, Tulip IT services and Tata Communications

#### Reliance Communications



#### Recent Research

Date	Company	Title	Price (INR)	Recos
03-Jul-09	Telecom	DoT visit highlights Sector Update		
03-Jul-09	Bharti Airtel	Healthy earnings visibility; Visit Note	818	Buy
01-Jul-09	Tulip Telecom	On track; Result Update	872	Buy
23-Jun-09	Telecom	Monthly subscriber Tracker; Sector Update		

#### Distribution of Ratings / Market Cap

##### Edelweiss Research Coverage Universe

	Buy	Hold	Reduce	Total
Rating Distribution*	53	43	29	128
* 3 stocks under review				
	> 50bn	Between 10bn and 50 bn	< 10bn	
Market Cap (INR)	72	41	15	

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