Bharti Airtel – BUY

BHARTI IN	Rs285	Telecom	11 June 2010	Company update

Calm between storms

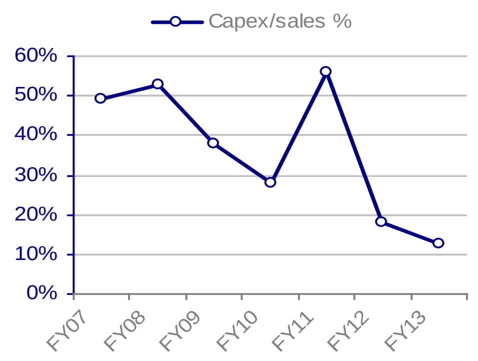
A tumultuous chain of news/events is nearing an end: on Zain, 2G (TRAI recommendations), 3G, and 4G (the BWA auctions reached Rs128bn for pan India spectrum, with excess demand seen only in Kerala after 116 rounds). Bharti's guidance on Zain is significantly better than our estimates on capex. This may neutralise the impact of expenses on 3G and BWA, and hence we maintain our FY11-12 earnings estimates. Meanwhile, in its FY10 US GAAP annual report, Bharti has disclosed that it increased its stake in the Telemedia business from 40% to 95% during 3QFY10, at a nominal sum of Rs74.8m, which in our opinion is a significantly value-accretive move. We retain BUY with TP of Rs362.

BWA auctions reach dizzying levels: The ongoing BWA auctions are clearly an indication that operators are unwilling to speculate about life without spectrum, given policy uncertainty. We gather that operators are attempting BWA spectrum in the same circles in which they have got 3G—an astute strategy that we believe will promote orderly development of the broadband market over time, instead of overcrowding. After 116 rounds, the pan-India price has reached Rs128bn, and Bharti's final spectrum tab should reach US$3.5bn.

Zain revenue and EBITDA guidance in line with estimates: Management commentary has been along expected lines: 1) that Bharti will take a measured country-wise approach to tariff cuts; 2) will develop tower-sharing arrangements in Africa to bring down system costs and take the lead in driving penetration; and 3) will chase a revenue target of US$5bn and EBITDA margin of 40% in three years (marginally higher than our estimates). However, the commentary is rather too bullish on currencies and interest cost.

Telemedia stake increased to 95%: The US GAAP annual report suggests that Bharti raised its ownership in the Telemedia business from 45% to 95% at a nominal cost in 3Q, though it did not feature in the 3Q report. This strengthens Bharti's potential payoff streams from convergence, and rural presence. In the domestic market, regulators' capriciousness and the potential entry into telecom of Mukesh Ambani are key risks.

Capex commitments will peak in FY11, owing to 3G/BWA and Zain



Source: IIFL Research

Financial Summary

Y/e 31 Mar	FY08A	FY09A	FY10ii	FY11ii	FY12ii
Revenues (Rs m)	369,615	396,150	568,324	685,478	748,208
EBITDA Margins (%)	41.0	40.5	37.9	38.4	40.7
Pre-Exceptional PAT (Rs m)	84,700	91,023	71,255	82,819	102,718
Reported PAT (Rs m)	84,700	91,023	71,255	82,819	102,718
EPS (Rs)	22.3	24.0	18.8	21.8	27.0
Growth (%)	26.4	7.4	-21.7	16.2	24.0
PER (x)	12.8	11.9	15.2	13.1	10.6
ROE (%)	32.2	25.4	15.4	16.1	17.3
Debt/Equity (x)	0.2	0.0	1.3	1.0	0.8
EV/EBITDA (x)	7.5	6.6	**7.6**	**6.1**	**5.3**
Price/Book (x)	3.7	2.7	2.3	2.0	1.7

Price as at close of business on 10 June 2010

12-mth TP	***(Rs) 362 (27%)***
Market cap (US$ m)	**23,058**
52Wk High/Low (Rs)	485/230
Diluted o/s shares (m)	3798
Daily volume (US$ m)	44
Dividend yield FY10ii (%)	0.4
Free float (%)	32.2

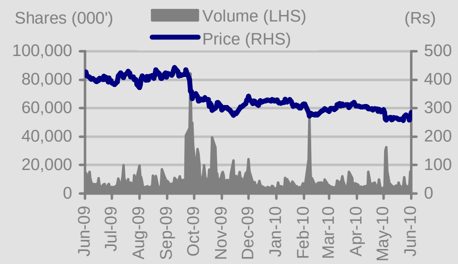
Shareholding pattern (%)

Promoters	67.8
FIIs	17.5
DIIs	7.9
Others	6.8

Price performance (%)

	1M	3M	1Y
Bharti	-3.1	-1.0	-31.7
Rel. to Sensex	-0.8	0.1	-41.1
RCOM	13.1	7.1	-50.2
Idea	-12.4	-10.2	-33.2
MTNL	-22.4	-27.5	-51.6

Stock movement



G V Giri
gvgiri@iiflcap.com
91 22 4646 4676

Mudit Bali
mudit.bali@iiflcap.com
91 22 4646 4672

Zain revenue and EBITDA guidance in line with estimates: Bharti's management has given some early directions following the closure of the Zain deal (*we imagine it may be called BAIN—Bharti Africa International Networks*), and some of these have been in line with our assessment: 1) that Bharti will take a measured approach to tariff cuts, and on a country-wise basis, and not take a cowboy approach; 2) Bharti will use Infratel to develop tower-sharing arrangements in Africa to bring down system costs and take the lead in driving penetration; 3) revenue target of US$5bn and EBITDA margin of 40% in three years (marginally higher than our estimates).

Zain borrowing at very favourable debt terms, though forex risks remain: Management has stated that the interest cost of Zain is only US$200m, and that the hedging will not be US$/INR, but US$ vs African currencies. We believe the currency risk can be hedged in two ways: through FX forwards in the local currency, or by local currency borrowing. In our opinion, in neither case will the hedge be complete in present value terms, because for an EBITDA of US$1.2bn and EV/EBITDA of 7x, US$8.4bn equivalent in different African currencies has to be hedged against US$, and local markets lack such depth.

Further, in both cases, the interest / hedging cost @6-7% will get loaded on Zain's P&L. Also, the company has not yet confirmed that there would be a tax benefit from the Zain borrowing. Our expectation is that the borrowing cost of the US$8.5bn loan is not tax-deductible.

China slowdown can impact Bharti: The reason for our caution is that if there is weakness of any significance emanating from a China slowdown, or from Europe, 3-4 factors can at once be expected to move in correlation: 1) the US$ will rise against all currencies, especially emerging market / African currencies, putting pressure on the African LCY pegs; 2) the inter-bank market will cool off and Libor rise; 3) crude will dip — a sustained weakness will dampen prospects in Nigeria, and a few other oil-dependent African economies.

Further, in the coming quarters, even if African currencies stay stable against the US$, the company will display FX gains / losses (US$/INR) on the US$ loan in the P&L (US GAAP); on the other hand, translation losses / gains on US$-linked asset will get absorbed in the consolidated P&L line by line.

Lastly, only incremental fluctuations in the value of the US$8.5bn loan from the time of the final payment (7 June) will flow into the P&L for 1QFY10 (the fact that the US$/INR was 44.5 at the time of the deal announcement but has since moved to 47.0 will not matter).

Capex to be around US$800m in the first year lower than our initial estimate: On capex, we have factored in US$4.4bn from now to end-FY13, whereas management is guiding for <US$1bn (for the first year). This is significantly lower than our estimates, at least for the first year. We believe that the assumption that equipment suppliers will be willing to supply at India rates for the entire African requirement is a bit risky; the most likely outcome is that Bharti is able to cut Zain's average unit costs by 30%+. Based on this, we would be tempted to cut our capex estimates, at least for the first year, but we leave them unchanged, as any gains here are likely to be eaten away in the 3G BWA auctions.

Figure 1: Assumptions on Zain (US$ m)

Financial Summary	2008	2009	9ME 3-2011	FY12	FY13
Revenue	4,091	3,641	2,982	4,336	4,770
Revenue growth (%)		-11.0%	57.2%	45.4%	10.0%
Op Ebitda margin (%)	33.7%	31.8%	33.3%	36.0%	40.0%
EBITDA	1,379	1,159	994	1,560	1,909
EBIT	439	149	216	441	722
Profit before tax	377	-144	67	236	504
Minorities and other	-56	45	-5	-30	-71
Net profit	225	-148	15	99	236
Capex / Sales %	-38.4%	-30.9%	-41.0%	-37.0%	-32.0%
Capital expenditure	-1,571	-1,126	-1,223	-1,604	-1,526
Free cash flow	-350	-309	-426	-357	-83
Net Debt		1,700	2,410	2,767	2,850

Source: Bloomberg, IIFL Research

4G > 3G?

Figure 2: Ongoing BWA auctions have seen intensive bidding, but now appear to be in final stages (figures in Rs m)

Circle	PW price	Agg demand	Excess demand	Base price	Increment	3G price	BWA/3G
Delhi	22,210	2	0	1,600	200	33,169	67.0%
Mumbai	22,730	2	0	1,600	200	32,471	70.0%
Kolkata	5,232	1	-1	600	0	5,443	96.1%
MH	9,156	1	-1	1,600	0	12,578	72.8%
Gujarat	6,078	1	-1	1,600	0	10,761	56.5%
A.P.	10,591	2	0	1,600	105	13,731	77.1%
KN	15,433	2	0	1,600	154	15,799	97.7%
TN	20,495	2	0	1,600	200	14,649	139.9%
Kerala	2,587	3	1	600	25	3,125	82.8%
Punjab	3,323	1	-1	600	0	3,220	103.2%
Haryana	1,187	2	0	600	11	2,226	53.3%
U.P.(E)	1,411	2	0	600	14	3,646	38.7%
U.P.(W)	1,839	1	-1	600	0	5,140	35.8%
Rajasthan	964	1	-1	600	0	3,210	30.0%
M.P.	1,234	2	0	600	12	2,584	47.8%
W.B.	710	1	-1	600	0	1,236	57.4%
H.P.	207	2	0	150	2	372	55.5%
Bihar	983	1	-1	150	0	2,035	48.3%
Orissa	630	1	-1	150	0	970	65.0%
Assam	327	2	0	150	3	415	78.8%
North East	211	2	0	150	2	423	49.8%
J&K	211	2	0	150	2	303	69.5%

Source: TRAI, IIFL Research

BWA auctions—spectrum at any cost? The ongoing BWA auctions are clearly an indication that operators are unwilling to speculate about life without spectrum, given policy uncertainty. We gather that operators are attempting BWA spectrum in the same circles in which they have got 3G—an astute strategy that we believe will promote orderly development of the broadband market over time, instead of overcrowding. After 116 rounds, the pan-India price reached Rs128bn, and Bharti's final spectrum tab should reach US$3.5bn.

But there is a limit to desperation, after all: As evident from Figure 2, most circles have zero or negative excess demand, indicating that there may after all, be a limit to desperation, and we are in the last few days of the auction. As a percentage of 3G price, Tamil Nadu and Punjab have had the highest bids (Punjab had four 3G slots, leaving the 3G price in the circle to be relatively lower). Kolkata and Karnataka are also close to their 3G prices.

Telemedia stake increased to 95% at a nominal cost

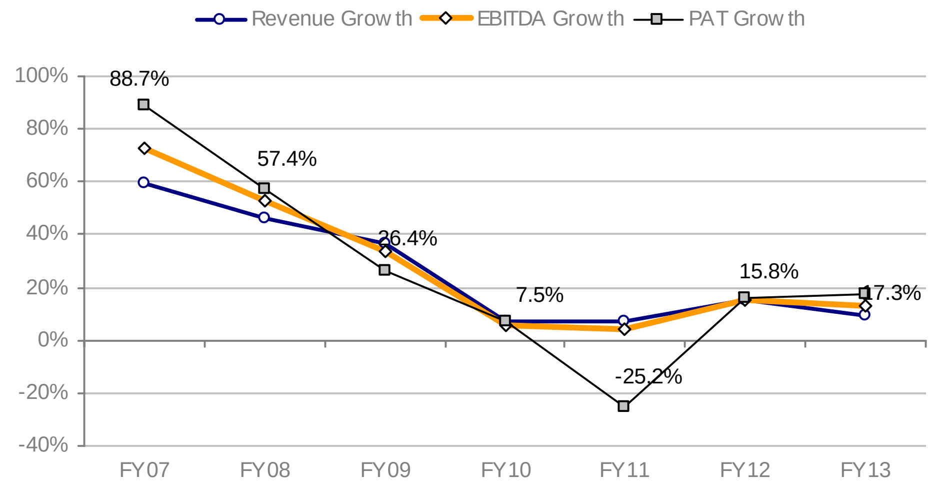
According to Bharti's US GAAP annual report, the company raised its ownership in the Telemedia business from 45% to 95% at a nominal cost, in 3Q, though it was not reported in the 3Q report. This strengthens Bharti's potential payoff stream from convergence, and rural presence. Domestic regulators' capriciousness and the potential entry into telecom of Mukesh Ambani are key risks.

Figure 3: Year-end key performance indicators

Mobile	FY07A	FY08A	FY09A	FY10A
Year-end subscribers	37.1	62.0	93.9	127.6
ARPU (Rs)	416	366	325	244
ARPU change		-11.9%	-11.4%	-24.7%
MOU	459	482	512	459
RPM (Rs)	0.91	0.76	0.63	0.53
Telemedia	**FY07A**	**FY08A**	**FY09A**	**FY10A**
Revenue	22,454	28,484	33,517	34,154
EBITDA %	24.8%	39.3%	41.5%	42.1%
Capex-to-sales %	39.7%	34.4%	41.4%	29.2%
Enterprise		**FY08A**	**FY09A**	**FY10A**
Revenue		13,217	16,945	16,012
EBITDA %		45.5%	43.8%	60.0%
Capex to sales %		171.5%	118.4%	63.8%
Bharti Infratel			**FY09A**	**FY10A**
Revenue (Rs m)			42,489	35,425
EBITDA %			34.6%	44.9%
Capex-to-sales %			990.6%	84.2%

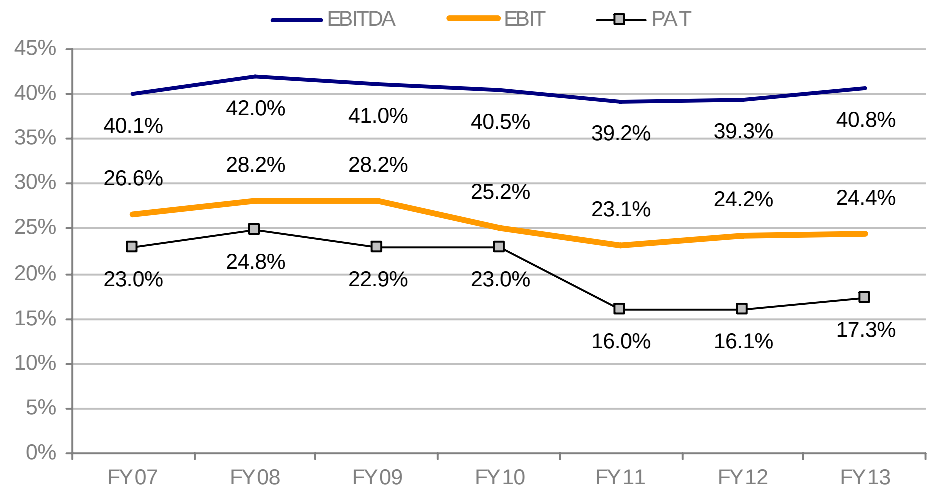
Source: IIFL Research

Figure 4: FY10 saw muted revenue growth due to increased price competition



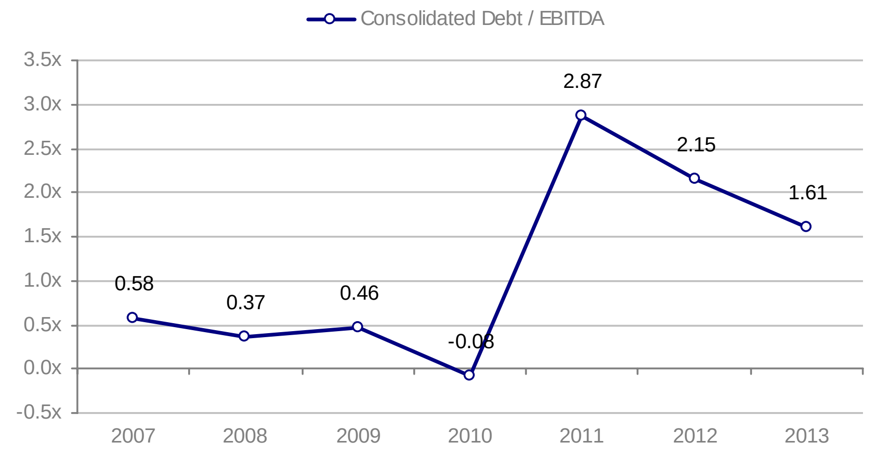
Source: Company, IIFL Research

Figure 5: Despite the competition storm, margins have been stable



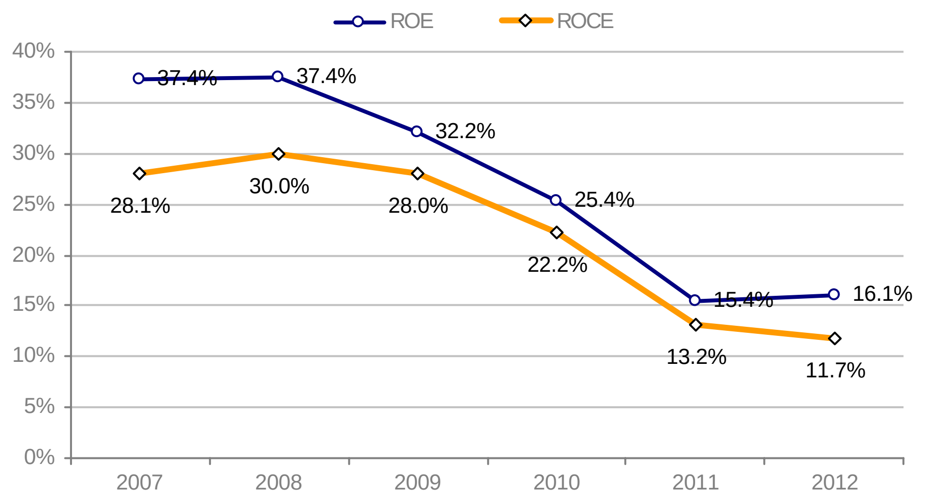
Source: Company, IIFL Research

Figure 6: FY11 Net debt-to-EBITDA to should decline after a Zain / Spectrum spike



Source: Company, IIFL Research

Figure 7: Return ratios will be adversely affected on account of the Zain consolidation and higher interest cost



Source: Company, IIFL Research

Financial summary

Income statement summary (Rs m)

Y/e 31 Mar	FY08A	FY09A	FY10ii	FY11ii	FY12ii
Revenue	369,615	396,150	568,324	685,478	748,208
EBITDA	151,677	160,268	215,243	263,104	304,159
EBIT	**104,097**	**99,812**	**111,680**	**138,673**	**163,272**
Interest income	4,730	4,585	3,802	3,843	3,820
Interest expense	-4,418	-3,679	-29,661	-41,074	-35,004
Others items	-11,336	6,259	4,870	10,599	12,378
Profit before tax	**93,073**	**106,976**	**90,691**	**112,040**	**144,467**
Tax expense	-6,615	-13,959	-16,411	-23,207	-33,196
Extraordinary items	-1,758	-1,994	-3,026	-6,013	-8,553
Net Profit	**84,700**	**91,023**	**71,255**	**82,819**	**102,718**

Cashflow summary (Rs m)

Y/e 31 Mar	FY08A	FY09A	FY10ii	FY11ii	FY12ii
Profit before tax	93,073	106,976	90,691	112,040	144,467
Depreciation & Amortization	47,581	60,456	103,562	124,431	140,887
Tax paid	-10,400	-22,145	-14,734	-20,450	-29,882
Working capital change	-19,789	31,886	6,988	4,554	-1,015
Other operating items	8,437	2,925	-294	-297	-300
Operating Cash-flow	**118,902**	**180,097**	**186,213**	**220,277**	**254,157**
Capital expenditure	-139,713	-112,478	-294,754	-162,317	-136,033
Free cash flow	**-20,811**	**67,619**	**-108,541**	**57,960**	**118,124**
Equity raised	0	23,640	0	0	0
Investments	10,141	-25,250	49,345	-9,523	-11,312
Debt financing/disposal	23,831	-76,434	493,438	-29,193	-119,941
Dividends paid	0	-4,443	-4,443	-6,665	-19,994
Other items	-8,793	17,621	-414,172	-10	-10
Net change in Cash & cash equivalents	**4,368**	**2,753**	**15,627**	**12,569**	**-33,133**

Source: Company data, IIFL Research

Balance sheet summary (Rs m)

Y/e 31 Mar	FY08A	FY09A	FY10ii	FY11ii	FY12ii
Cash & cash equivalents	49,070	77,029	76,284	88,852	55,719
Sundry debtors	28,528	24,335	57,275	62,275	68,146
Trade Inventories	963	484	3,165	3,367	3,697
Other current assets	65,518	37,494	45,387	48,865	51,954
Fixed assets	**409,136**	**443,808**	**944,201**	**982,087**	**977,233**
Intangible assets	40,364	52,675	215,059	215,059	215,059
Other assets	10,370	10,578	89,056	98,589	109,912
Total assets	**603,948**	**646,404**	**1,430,428**	**1,499,095**	**1,481,721**
Short-term debt	64,808	17,166	155,000	125,000	75,300
Sundry creditors	18,771	21,372	82,355	87,338	90,812
Other current liabilities	133,606	109,573	118,701	126,952	121,206
Long-term debt/Convertibles	53,993	47,452	529,000	529,750	470,000
Other long-term liabilities	18,120	8,656	10,095	12,611	15,682
Minorities/other Equity	10,704	28,489	54,770	60,784	69,337
Net worth	**303,945**	**413,695**	**480,506**	**556,660**	**639,384**
Total liabilities & equity	**603,948**	**646,404**	**1,430,428**	**1,499,095**	**1,481,721**

Ratio analysis

Y/e 31 Mar	FY08A	FY09A	FY10ii	FY11ii	FY12ii
Revenue growth (%)	36.8	7.2	43.5	20.6	9.2
Op Ebitda growth (%)	33.8	5.7	34.3	22.2	15.6
Op Ebit growth (%)	36.7	-4.1	11.9	24.2	17.7
Op Ebitda margin (%)	41.0	40.5	37.9	38.4	40.7
Op Ebit margin (%)	28.2	25.2	19.7	20.2	21.8
Net profit margin (%)	22.9	23.0	12.5	12.1	13.7
Dividend payout (%)	5.2	4.9	9.4	24.1	32.4
Tax rate (%)	-7.1	-13.0	-18.1	-20.7	-23.0
Net debt/equity (%)	22.9	-3.0	126.5	101.7	76.6
Net debt/op Ebitda (x)	46.0	-7.7	282.3	215.1	161.0
Return on equity (%)	32.2	25.4	15.9	16.0	17.2
ROCE (%)	28.0	22.2	13.6	11.7	13.6
Return on assets (%)	27.8	23.6	11.8	10.2	12.0

Source: Company data, IIFL Research

Key to our recommendation structure

BUY - Absolute - Stock expected to give a positive return of over 20% over a 1-year horizon.
SELL - Absolute - Stock expected to fall by more than 10% over a 1-year horizon.

In addition, **Add** and **Reduce** recommendations are based on expected returns relative to a hurdle rate. Investment horizon for **Add** and **Reduce** recommendations is up to a year. We assume the current hurdle rate at 10%, this being the average return on a debt instrument available for investment.

Add - Stock expected to give a return of 0-10% over the hurdle rate, ie a positive return of 10%+.
Reduce - Stock expected to return less than the hurdle rate, ie return of less than 10%.
