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Sector: Telecom Services

Food For Thought

Proposed deal with MTN to provide access to under penetrated African & Middle East markets with relatively higher ARPU...

...but also result in significant earnings dilution over short term which could negatively impact stock price

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*Research Contact: Associate Director, Research: Hitesh Kuvelkar Mob. +91 9833 732633
Email: hitesh.kuvelkar@fglobal.com*

*Sales Offices: India Sales: Tel. No: +91-22-400 12 440 Email: indiasales@fglobal.com
fgindiasales@bloomberg.net*

US Sales: Tel. No: 1-212-227 6611 Email: us@fglobal.com

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The Story...

Bharti Airtel Ltd. (BHARTIARTL) (BHARTI.IN) (BRTI.BO), India's largest telecom service provider, has announced plans to renew talks with MTN Group Limited (MTN) in order to develop a significant partnership between the two companies. Bharti and MTN have agreed to discuss the potential transaction exclusively with one another until July 31, 2009. As per the proposed deal, Bharti will acquire a 49% shareholding in MTN, which, along with its shareholders, will acquire an economic interest of approximately 36% in Bharti, out of which 25% will be held by the MTN Group, while the remainder will be held directly by MTN's shareholders. As part of its strategy to expand its global presence, Bharti had earlier tried to negotiate a deal with MTN in May 2008. However, following several rounds of negotiations, the talks were called off when MTN proposed a new structure, which envisaged Bharti as its subsidiary and the exchange of a majority of Bharti's shares held by the Bharti family and Singtel in exchange for a controlling stake in MTN.

The renewed deal is being described as a merger of equals. Both Bharti and MTN have 100 mn subscribers each (as of April 2009) and are the major telecom players in India and Africa respectively. The deal, if completed, will make the Bharti-MTN combined entity the world's third largest mobile operator after China Mobile and Vodafone, in terms of the number of subscribers. The proposed deal will provide Bharti a majority stake in MTN, which, in turn will enjoy a majority stake in Bharti Airtel. The deal will also expand Bharti's presence to an additional 21 nations. However, it will not be possible for Bharti to complete the deal without its balance sheet being impacted and equity being diluted. The deal will also result in a significant earnings dilution for Bharti in the short term. Read on for details...

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Overview of Bharti & MTN

Revenues, margins & PAT of Bharti & MTN

	Bharti Airtel	MTN
Revenue (FY09/CY08) (USD bn)	7.7	12.3
EBITDA Margin	40.6	42.1
PAT % (FY09/CY08)	22.9	14.9
Subscriber base (March 2009) (mn)	93.9	98.2

Source: Company Reports



Key Highlights

- Bharti will acquire a 49% shareholding in MTN, which along with its shareholders, will acquire an economic interest of approximately 36% in Bharti, out of which 25% will be held by MTN and the remainder by its shareholders.
- The combined entity will have a customer base of 200 mn subscribers (100 mn subscribers each of Bharti and MTN) and combined revenues of over \$20 bn.
- Bharti will act as the primary vehicle for both Bharti and MTN for pursuing further expansion in India and Asia, while MTN will be the primary vehicle for both Bharti and MTN for further expansion in Africa and the Middle East.
- As per the proposed scheme of arrangement, MTN will acquire a post-transaction economic interest of approximately 25% in Bharti for an effective consideration of about \$2.9 bn in cash and newly-issued shares of MTN, close to 25% of the currently issued share capital of the South African firm.
- Bharti will acquire approximately 36% of the currently issued share capital of MTN from its shareholders for a consideration of ZAR 86.00 in cash and 0.5 newly issued shares of Bharti in the form of Global Depository Receipts (GDRs) for every acquired share of MTN which, in a combination with MTN's shares issued in part settlement of its acquisition of a post-transaction economic interest of approximately 25% in Bharti, will take the company's stake to 49% of MTN's enlarged capital.
- Each GDR will be equivalent to one share in Bharti and will be listed on the securities exchange operated by JSE Limited, South Africa.
- Bharti will have substantial participatory and governance rights in MTN, thus enabling it to fully consolidate the company's accounts.
- MTN's economic interest in Bharti will be equity accounted and the company will enjoy appropriate representation on its board.
- Singapore Telecommunications, Bharti's major existing shareholder, will continue to be a strategic partner and a significant shareholder after the implementation of the potential transaction.

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Overview of African & Middle East Telecom Market

The Middle East and North Africa (MENA) market has significant growth potential due to low mobile penetration. Moreover, except for Cyprus, the ARPU of these regions is lower in comparison to that of the WECA and SEA

MTN operates across 21 geographies in Africa and the Middle East. A major portion of MTN’s revenues come from the South and East Africa (SEA) and West and Central Africa (WECA), where it operates in 15 nations, while the contribution from the Middle East and North Africa (MENA) is low. However, the Middle East and North Africa (MENA) market has significant growth potential due to low mobile penetration. Moreover, except for Cyprus, the ARPU of these regions is lower in comparison to that of the WECA and SEA.

Region wise revenue & margin contribution

Operating Areas	Revenue Contribution	EBITDA Margin	PAT Margin
West & Central Africa	42%	53%	21%
South & East Africa	43%	36%	20%
Middle East & North Africa	15%	23%	7%

Source: Company Reports

The proposed deal is expected to provide Bharti access to the under penetrated African and Middle East market. However, the story is a bit different for the other geographies. Africa’s demographic profile is quite different from that of the rest of the world, with some markets having a population of less than 1 mn and others having a population of less than 5 mn. There are regions (marked in blue in graph below) with a high GDP/per capita, but with a mobile penetration of over 80%, thus leaving little scope for further expansion. There are also regions (marked in yellow in graph below) with very low mobile penetration, but having a very low GDP/per capita (less than \$1000). It still remains to be seen as to how Bharti will implement its low cost model in Africa. What is noteworthy is that these nations have a GDP/per capita that is even lower than that of India at \$1016. The regions marked in green in the graph below have the maximum potential for growth, due to their moderate GDP/per capita and significant scope for increase in mobile penetration.

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Region wise mobile penetration, GDP/per capita, ARPU & market share

Operating Nations	Mobile Penetration	GDP/Per Capita (USD)	ARPU (USD)	Market Share
West & Central Africa				
Nigeria	28%	1451	13	43%
Ghana	33%	716	8	52%
Cameroon	25%	1199	9	59%
Cote d'Ivoire	33%	1132	9	38%
Congo B	35%	184	12	26%
Benin	23%	856	13	36%
Bissau	21%	264	10	72%
Guinea Conarky	15%	442	8	53%
Liberia	17%	212	12	54%
South & East Africa				
South Africa	86%	5693	R139	36%
Uganda	15%	453	7	56%
Botswana	80%	7554	10	65%
Zambia	13%	1150	6	17%
Swaziland	40%	2781	11	100%
Rwanda	7%	465	7	96%
Middle East & North Africa				
Sudan	21%	1519	5	28%
Iran	37%	4732	8	23%
Afghanistan	15%	429	5	25%
Cyprus	82%	32772	36	15%
Syria	35%	2757	17	45%
Yemen	17%	1182	7	40%

Source: Company Reports
GDP/Per Capita: IMF Report 2008



Is the deal value accretive?

The deal will also result in significant equity dilution as well as have a significant negative impact on Bharti's EPS in the short term

The proposed deal with MTN will provide Bharti access to the African and Middle East markets, expanding its presence in an additional 21 countries. In terms of global presence, Bharti currently has a presence only in Sri Lanka, Seychelles and Channel Island. However, the deal will also result in significant equity dilution as well as have a significant negative impact on Bharti's EPS in the short term. The deal will also lead to an additional debt burden of approximately USD 4 bn for funding the deal.

Shareholding pattern of Bharti & MTN post deal

	Bharti Airtel	MTN
Current Number of shareholders (in mn)	1898	1869
MTN will issue new shares to Bharti (25% of its current capital) (in mn)		467.25
Bharti Airtel will acquire 36% of existing shares from shareholders (in mn)		672.8
Will issue 0.5 new share of Bharti for each share of MTN (in mn)	336.4	
Bharti Airtel will pay ZAR 86 per share in cash to MTN shareholders (USD mn)	6972.6	
Bharti Airtel will issue new shares to MTN to account for 25% post transaction equity (in mn)	744.7	
Post transaction share count (in mn)	2979	2336
Bharti Airtel Holding in MTN post transaction		49%
MTN holding in Bharti post transaction	25%	
MTN shareholders holding in Bharti post transaction	11%	
Cash inflow to Bharti Airtel from MTN (USD mn)	2900	
Cash outflow for Bharti Airtel (USD mn)	6973	
Net cash outflow for Bharti Airtel(USD mn)	4073	

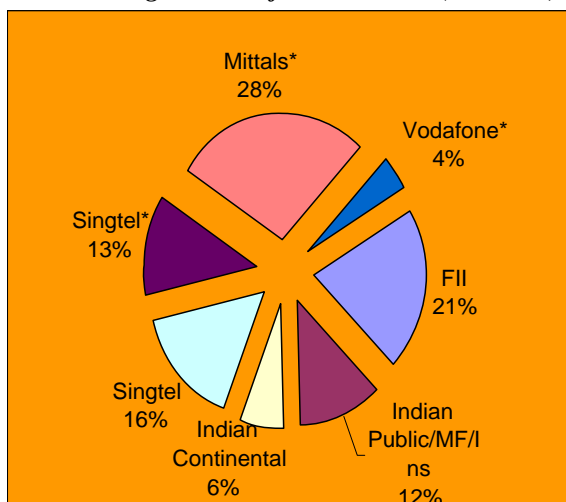
Source: FG Estimates

Bharti's shareholding structure

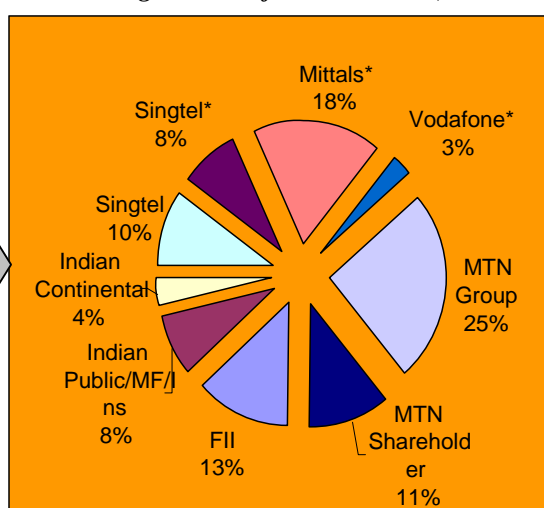
Bharti Telecom (Mittals*, Vodafone* and Singtel*) was the major stakeholder in Bharti, before the transaction with a 45.3% stake. Singtel also had a direct stake of 16% in Bharti. There are still speculations over the shareholding pattern, post the deal, which will enable Bharti to obtain FDI clearance for the deal. A possible shareholding pattern, post the deal, could be one in which Bharti remains the major shareholder, but with its stake diluted to 29%, followed by the MTN Group with a stake of 25%.



Shareholding Pattern of Bharti Airtel (Pre Deal)



Shareholding Pattern of Bharti Airtel (Post Deal)



Source: Company Reports, FG Estimates

Estimated EPS dilution of Bharti Airtel...

The proposed merger, if completed, will result in an increase in Bharti's shares from 1898 mn to 2979 mn, marking a dilution of 57% in the company's shares. Assuming that the merger is effective from April 1, 2009, the deal will result in a dilution of 9% in Bharti's EPS for FY10E.

Estimated EPS dilution

	FY10E	FY11E
Bharti Net Profit (Rs. mn)	97719	108171
Bharti's Net Profit (USD mn)	2053	2273
EPS (Rs.)	51.5	57.0
Incremental debt for Bharti (USD mn)	4073	4073
Incremental interest costs ¹ (post tax) USD mn	225	225
MTN net profit estimates* (ZAR mn)	19806	23875
MTN net profit estimates (USD mn)	2386	2877
Incremental debt for MTN	2900	2900
Incremental Interest costs ¹ (post tax) USD mn	160	160
Bharti's share of MTN profit (49%)	1091	1331
Bharti's net profit post deal (USD mn)	2919	3379
Bharti's net profit post deal (Rs. mn)	138921	160826
Bharti's share count post deal	2979	2979
Bharti EPS post deal (Rs.)	46.7	54.0
EPS dilution from the deal	-9%	-5%

Source: FG Estimates

*MTN profits are consensus estimates

¹: Interest rate of 8.5% and tax rate of 35% have been assumed

Note: For conversion 1 USD: Rs.47.6, 1 ZAR: USD 0.1205



Our Take

The proposed deal with MTN will provide Bharti access to markets across the Africa and Middle East that are under penetrated and have a relatively higher ARPU in comparison to that in India. With Indian service providers already struggling against declining ARPUs and stagnating subscriber additions, Bharti views the deal with MTN as an additional source of revenue generation over the long term. However, MTN already has 100 mn subscribers and its geographies with a high GDP/per capita are already saturated. Bharti will, thus, find it a tough task to increase the number of subscribers in geographies with a low population and GDP/per capita. There are regions, such as Nigeria, Iran, Syria,

which have potential for growth, though the amount of value addition from these regions for Bharti still remains to be seen. Since MTN operates across 21 geographies, there could also be integration issues and delay in unlocking of synergies between the two entities. The deal will also result in a significant earnings dilution for Bharti over the short term, which could have a significant negative impact on its stock price.

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FG Markets, Inc.
90 John Street, Suite 703,
New York, NY 10038
Dealing Desk (US):
Tel. No.: +1-212-227 6611
Email: us@fglobal.com

FIRST GLOBAL
Nirmal, 6th Floor, Nariman Point,
Mumbai - 400 021, India.
Dealing Desk (India):
Tel. No.: +91-22-400 12 400
Email: fgindiasales@bloomberg.net

FIRST GLOBAL (UK) Ltd.
The Cobalt Building, 19-20, Noel Street,
London W1F 8GW, United Kingdom
Dealing Desk (UK & Europe):
Tel. No.: +44-207-959 5300
Email: uk@fglobal.com

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