

Zee Entertainment Enterprises

BUY

Upgrade from Hold

Restructuring, a win-win deal

Rs227

Reason for report: Recommendation change and Q2FY10 results review

Zee Entertainment Enterprises (ZEEL) announced a restructuring deal, wherein it will acquire Zee News' (ZNL) regional general entertainment channels (R-GECs) in lieu of its shares. ZNL's R-GECs offer a strong franchise of regional properties, which are highly profitable and offer better growth opportunities. R-GECs reported Rs3.4bn and Rs1.87bn revenues and Rs797mn and Rs597mn EBITDA in FY09 and H1FY10 respectively. We expect R-GECs to be valued at 13x FY10E EV/E (at 20% discount to ZEEL's EV/E) along with debt assumption of Rs1.5bn, implying an equity value of Rs14.4bn or Rs60/share for R-GECs. This implies 60% premium to ZNL's market valuation, which, we believe, is justified as the deal is EPS-accretive for ZEEL and offers better synergies and opportunity to explore new revenue streams. ZEEL's Q2FY10 results were in line with expectations, with strong rebound in advertising. We raise target price to Rs236 from Rs200 based on FY11E P/E of 20x. Restructuring will lead to higher stability in earnings and lower dependence on the flagship channel, Zee TV, which will drive ZEEL's valuations. Also, primary market issuances by cable distributor such as DEN and Hathway will provide further fillip to the digitalisation wave, leading to stronger Pay TV growth. Upgrade to BUY. The key risk is poor swap ratio. The deal is expected to be completed by March '10.

- **Q2FY10 results in line** with ad growth of 25% QoQ and DTH subs growth of 10% QoQ. Ad revenues, however, declined 13% YoY owing to rise in competition in Hindi GECs. Operating costs rose 8.6% QoQ led by 51.8% QoQ growth in SG&A expenses. EBITDA grew 29% QoQ driven by 331bps QoQ margin expansion to 27.9%. In spite of multiple new initiatives, programming costs declined 6.8% QoQ as high budget programmes with poor performance were replaced.
- **Restructuring to drive value.** The acquisition of ZNL's R-GECs by ZEEL will broaden base growth and will reduce dependence on the flagship channel Zee TV, which is under huge competitive pressure. Also, R-GECs offer better growth, higher margins and opportunity to explore new revenue streams by going international. While the Hindi GEC space is largely crowded, Marathi and Bengali GEC genres are underexplored and offer huge upside to Pay TV revenues.
- **Re-rating imminent; upgrade to BUY** from Hold as R-GECs offer stability and the deal is likely to be EPS-accretive even if ZNL is valued at 60% premium to the current market value. We raise target price to 236 from Rs200 and will review estimates after the swap ratio is announced. Our target price is based on FY11E P/E of 20x, assuming FY11E EV/EBITDA of 15x.

Media

Target price Rs236

Shareholding pattern

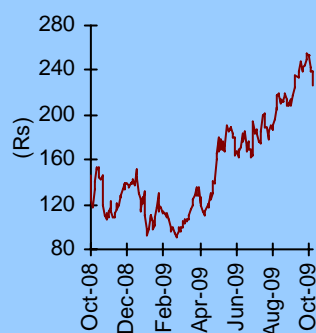
	Mar '09	Jun '09	Sep '09
Promoters	41.5	41.5	41.5
Institutional investors	50.3	50.0	50.7
MFs and UTI	10.0	11.9	14.4
Insurance Cos.	10.8	10.6	10.5
FII's	29.5	27.5	25.8
Others	8.2	8.4	7.8

Source: NSE

Target price Rs236

Rs236 from Rs200

Price chart



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Market Cap	Rs98bn/US\$2.1bn
Reuters/Bloomberg	ZEE.BO/Z IN
Shares Outstanding (mn)	433.6
52-week Range (Rs)	255/90
Free Float (%)	58.5
FII (%)	29.5
Daily Volume (US\$/'000)	8,750
Absolute Return 3m (%)	23.3
Absolute Return 12m (%)	82.1
Sensex Return 3m (%)	9.3
Sensex Return 12m (%)	93.2

Year to Mar	2009	2010E	2011E	2012E
Revenue (Rs mn)	21,773	22,421	25,824	29,658
Rec. Net Income (Rs mn)	3,673	4,325	5,116	5,960
EPS (Rs)	8.5	10.0	11.8	13.7
% Chg YoY	(4.6)	17.8	18.3	16.5
P/E (x)	26.8	22.8	19.2	16.5
CEPS (Rs)	9.2	11.0	13.0	15.1
EV/E (x)	18.7	17.4	14.5	12.7
Dividend Yield (%)	0.9	1.0	1.1	1.3
RoCE (%)	8.7	7.3	8.3	13.0
RoE (%)	11.7	12.1	13.1	13.7

Restructuring, a win-win deal

ZEEL plans to acquire ZNL's R-GECs, which is a win-win deal as it will lead to significant value unlocking for ZNL's shareholders in the short term and will enable a re-rating of ZEEL provided the share swap ratio is not highly in favour of ZNL. We attribute an enterprise value of Rs15.9bn to ZNL's R-GECs based on 13x FY10E EV/EBITDA, which is at a 20% discount to ZEEL's multiple. Our valuation implies 1:3.77 share swap ratio in favour of ZEEL and provides a 59% upside for ZNL shareholders, while being EPS-accretive for ZEEL. As per our scenario analysis, a 1:5 swap ratio implies a 27% upside for ZNL shareholders, while being 5% EPS accretive for ZEEL.

Table 1: Sensitivity of ZEEL's dilution to swap ratio

(Rs mn)

	I-Sec	Scenarios		
Swap ratio	1:3.77	1:3	1:4	1:5
R-GEC implied valuation	14,410	18,142	13,607	10,885
Debt assumed	1,500	1,500	1,500	1,500
Enterprise value	15,910	19,642	15,107	12,385
Implied EV/EBITDA multiple	13.0	16.0	12.3	10.1
News business value @ 1x FY10E sales	2450	2450	2450	2450
ZNL's value	16,860	20,592	16,057	13,335
ZNL's share price (Rs)	70	86	67	56
Dilution for ZEEL (%)	14.7	18.5	13.8	11.1
EPS impact on ZEEL in FY11 (%)	1.7	(1.6)	2.4	5.0

Source: Company data, I-Sec Research

Regional GECs –Strong franchise

ZNL's R-GECs offer a strong franchise with *Zee Marathi* being the leader in its space and *Zee Bengali* a strong #2 player. *Zee Telugu* and *Zee Kannada* have also been able to establish themselves and are strong contenders for the #2 slot in their respective markets. Regional markets are relatively underpenetrated with ad spend per household at 39-67% discount to Hindi markets.

Table 2: Ad spend in regional markets at a discount to HSM

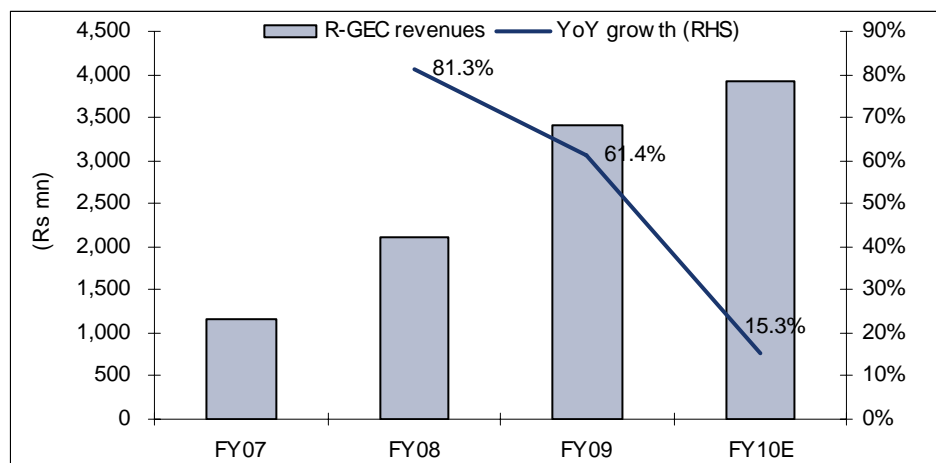
	Hindi	Bengali	Marathi	Tamil	Telugu	Kannada	Malayalam
Total Ad revenues (Rs mn)	51,000	3,000	3,000	7,080	6,600	4,000	2,250
No. of C&S HHs (mn)	47.1	6.9	8.3	10.8	12.0	7.0	3.9
Ad revenues per HH (Rs)	1,083	438	360	658	552	574	581
Discount to HSM (%)	-	60	67	39	49	47	46

Source: TAM, I-Sec Research

Table 3: ZNL's bouquet of Regional GECs

Channels	Launch	Genre	FY08 market size (Rs bn)	Viewership share (%)	Major competitors	Comments
Zee Marathi	Aug-99	Regional GEC	2.2	54.60	ETV Marathi, Mi Marathi, Star Pravah	Clear #1
Zee Bangla	Sep-99	Regional GEC	2.2	38.80	ETV Bangla, Aakash Bangla, Star Jalsha	#2; recently lost leadership to Star Jalsha
Zee Telugu	May-08	Regional GEC	5.5	11.70	Gemini TV, Eenadu TV, Teja TV	Closely competing for the #2 spot
Zee Kannada	Jun-08	Regional GEC	2.5	18.50	Udaya TV, ETV Kannada	Closely competing for the #2 spot
Zee Talkies	Aug-07	Marathi Movies	2.5			
Zee Cinemalu	Apr-09	Telugu Movies	2.5			

Source: TAM, I-Sec Research

Chart 1: Strong revenue growth for ZNL's R-GECs

Source: Company data, I-Sec Research

Table 4: Market share of ZNL's regional pack strong

(%)	Q4FY07	Q1FY08	Q2FY08	Q3FY08	Q4FY08	Q1FY09	Q2FY09	Q3FY09	Q4FY09	Q1FY10	Q2FY10*
Zee Bangla	36.8	37.5	36.1	41.6	46.9	44.3	38.8	33.1	33.7	27.6	25.7
Zee Kannada	5.9	6.6	5.6	5.6	9.9	15.3	16.8	17.1	14.8	12.3	14.8
Zee Marathi	45.9	47.8	45.1	50.7	53.7	55.1	54.6	55.0	49.8	46.4	40.7
Zee Telugu	6.4	5.4	6.8	8.3	11.1	10.7	11.7	14.2	14.6	15.5	14.6
Zee Tamizh								0.7	1.6	1.2	1.3

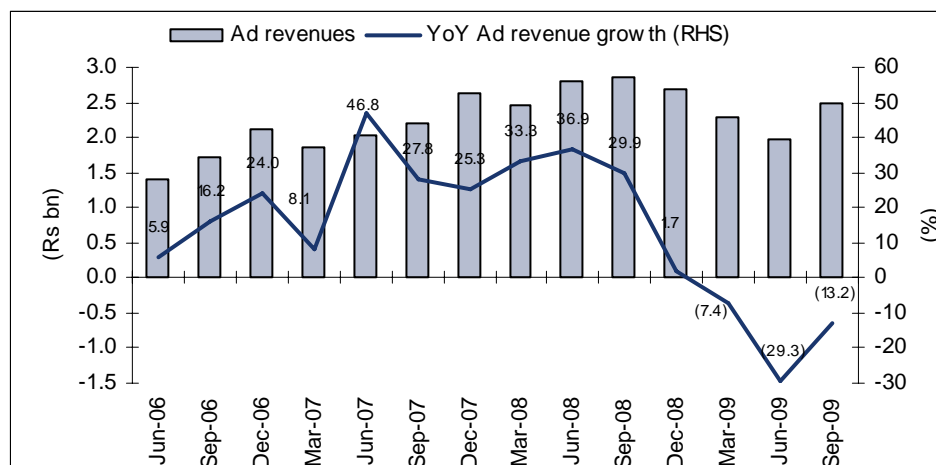
* August-September of CY09

Source: TAM; respective markets

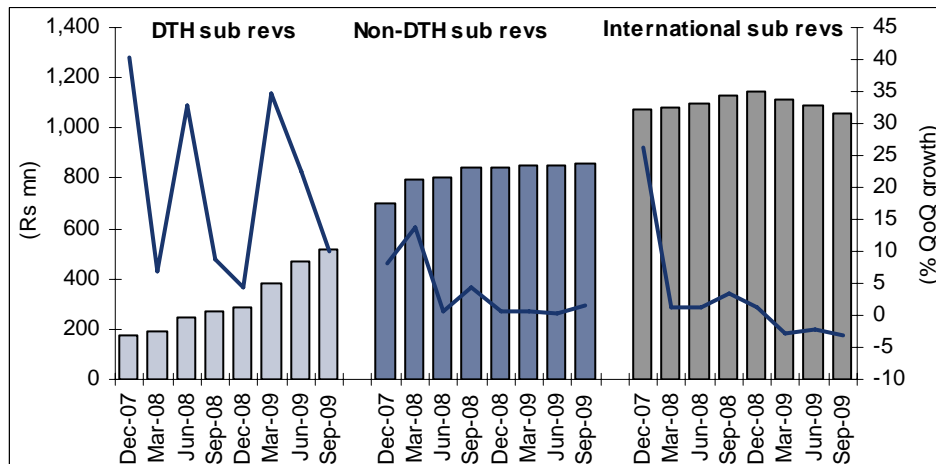
Q2FY10 results in line

Revenue growth driven by advertising pick-up

- **Ad revenue pick-up.** Ad revenues declined 13.2% YoY, but grew a strong 25% QoQ to Rs2,476mn, slightly higher than I-Sec estimates of Rs2,423mn, on account of improved market share in Hindi GECs with better programme performance and partial festival spending in Q2FY10.
- **Sports revenues jumped 21% QoQ** owing to high activity on account of the Compaq Cup, a cricketing event. EBITDA loss in Sports was curtailed to Rs48mn for the quarter.
- **Pay TV growth was at 1% QoQ** and 8.5% YoY owing to 3% QoQ decline in international subscription revenues. DTH revenues stood at Rs514mn, a strong growth of 10% QoQ and 90% YoY.

Chart 2: Ad revenue decline curtailed to 13% YoY

Source: Company data, I-Sec Research

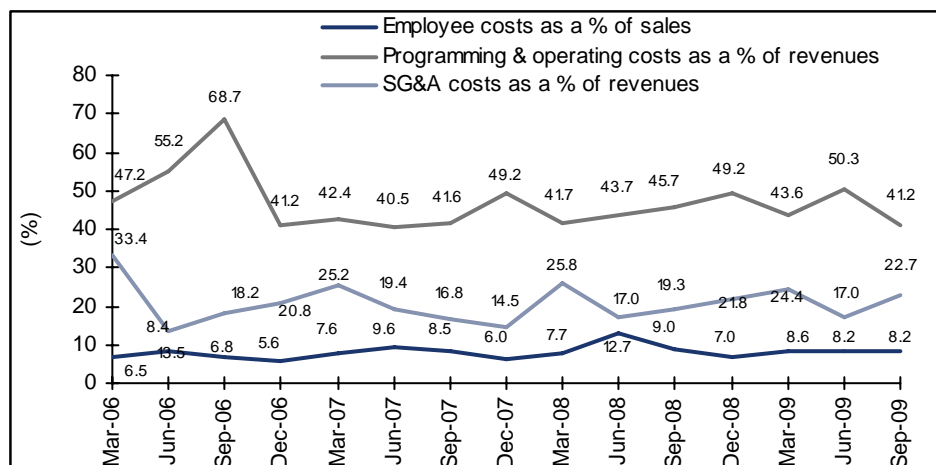
Chart 3: Subscription revenue growth led by DTH revenue growth

Source: Company data, I-Sec Research

EBITDA expands as costs curtailed; SG&A costs rises again

- EBITDA margin improved 331bps sequentially to 27.9% as programming costs declined 6.8% QoQ. However, SG&A costs grew 52% as advertising activity picked up. Improvement in profitability was largely driven by the Sports business, which contained its losses to Rs48mn versus Rs272mn loss in Q1FY10.
- PAT rose 12% QoQ to Rs1,141mn and was better than expectations (I-Sec: Rs1,022mn), mostly on account of margin expansion.

Chart 4: EBITDA margin improved 331bps QoQ



Source: Company data, I-Sec Research

Table 5: Q2FY10 results review – Consolidated

(Rs mn, year ending March 31)

	I-Sec estimates	Q2FY10	Q2FY09	YoY (%)	QoQ (%)	YTD FY10	YTD FY09	YoY (%)
Advertising revenues	2,423	2,476	2,851	(13.2)	25.1	4,456	5,649	(21.1)
Subscription revenues	2,581	2,435	2,244	8.5	1.0	4,845	4,394	10.3
Others Sales & service	407	494	621	(20.5)	33.5	864	1,092	(20.9)
Total revenues	5,411	5,405	5,716	(5.4)	13.6	10,164	11,136	(8.7)
Expenditure	4,089	3,897	4,228	(7.8)	8.6	7,486	8,206	(8.8)
Programming & operating cost	2,751	2,229	2,613	(14.7)	(6.8)	4,621	4,979	(7.2)
Staff cost	409	442	513	(13.8)	13.4	832	1,204	(30.9)
Admin & selling expenses	929	1,226	1,102	11.3	51.8	2,034	2,023	0.5
EBITDA	1,322	1,508	1,488	1.3	28.9	2,678	2,930	(8.6)
Other income	349	291	280	4.1	(10.5)	616	558	10.5
Depreciation	83	77	65	18.5	2.7	152	120	26.4
Finance Expenses	100	84	223	(62.3)	(7.8)	175	437	(59.9)
PBT	1,489	1,638	1,480	10.7	23.2	2,967	2,930	1.3
Exceptional item	-	0	(792)	NA		0	(1,366)	NA
Less: Provision for Tax	477	529	489	8.1	27.2	945	906	4.2
Reported PAT	1,013	1,109	1,782	(37.8)	21.4	2,022	3,389	(40.3)
Adjusted PAT	1,013	1,109	1,161	(4.5)	21.4	2,022	2,194	(7.8)
Minority Interest	(10)	(32.0)	(1.1)	2809.1	(69.8)	(137.8)	4.9	(2912.2)
Reported PAT after min. int.	1,023	1,141	1,783	(36.0)	12.0	2,160	3,384	(36.2)
Adjusted PAT after min. int.	1,023	1,141	1,162	(1.8)	12.0	2,160	2,189	(1.3)
Operating Margin (%)	24.4	27.9	26.0			26.3	26.3	
Gross Margin (%)	49.2	58.8	54.3			54.5	55.3	
Staff Cost to Revenues (%)	7.6	8.2	9.0			8.2	10.8	
Advertisement to Sales (%)	44.8	45.8	49.9			43.8	50.7	
Effective tax rate (%)	32.0	32.3	33.1			31.8	21.1	
NPM (%)	18.7	20.5	20.3			19.9	19.7	

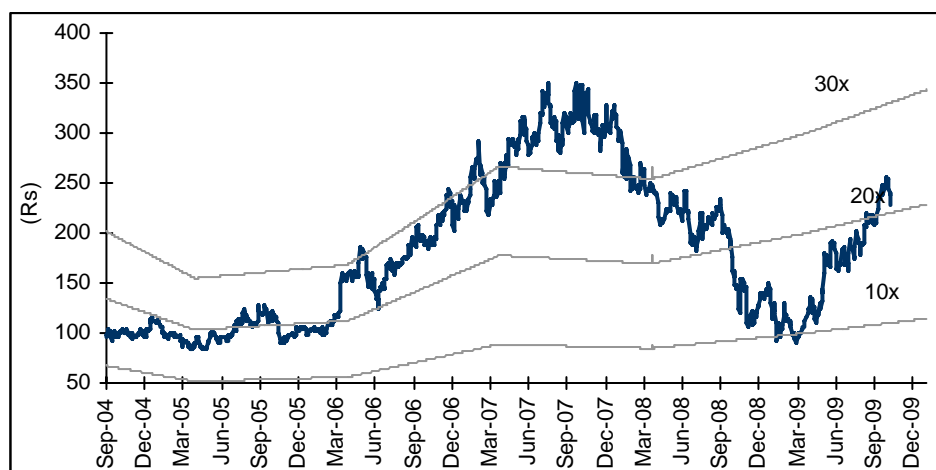
Source: Company data, I-Sec Research

Upgrade to BUY; target price revised to Rs236

We upgrade ZEEL to BUY from Hold as acquisition of R-GECs from ZNL offers higher stability and restructuring is expected to be EPS-accretive even if ZNL is valued at 60% premium to the current market value. We raise our target price to 236 from Rs200 and will revisit earnings estimates after the swap ratio is announced. Our target price is based on FY11E P/E of 20x, assuming 15x FY11E EV/EBITDA.

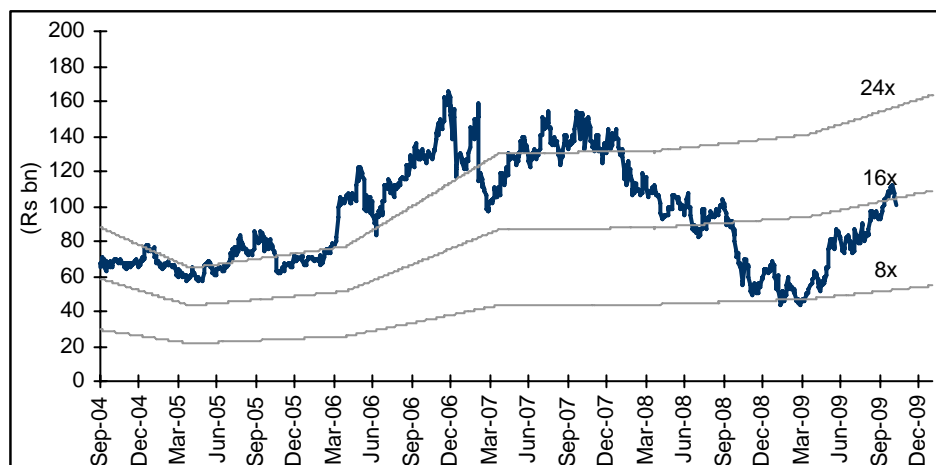
The revival in the advertisement market has been better than expected in the short term and the outlook for Zee TV continues to be strong as the new slate of programming has been well received. We expect primary market issuances by cable distributors such as DEN and Hathway to provide further fillip to the digitalisation wave, leading to strong momentum in Pay TV growth.

Chart 5: P/E bands



Source: Bloomberg, Company data, I-Sec Research

Chart 6: EV/EBITDA



Source: Bloomberg, Company data, I-Sec Research

Financial Summary

Table 6: Profit and Loss Statement

(Rs mn, year ending March 31)

	FY09	FY10E	FY11E	FY12E
Operating Income (Sales)	21,773	22,421	25,824	29,658
of which advertising	10,593	9,824	10,875	12,092
of which subscription	9,038	10,525	12,532	14,833
of which movies	331	371	463	579
of which others	1,812	1,702	1,954	2,154
Operating Expenses	16,293	16,553	18,780	21,635
EBITDA	5,480	5,869	7,044	8,023
% margins	25.2	26.2	27.3	27.1
Depreciation & Amortisation	310	436	510	566
Gross Interest	1,339	616	696	766
Other Income	1,572	1,682	1,850	2,036
Recurring PBT	5,403	6,499	7,688	8,726
Add: Extraordinaries	1,451	-	-	-
Less: Taxes	1,633	2,145	2,537	3,092
- Current tax	1,501	2,145	2,537	3,092
- Deferred tax	108	-	-	-
Less: Minority Interest	948	977	1,012	1,054
Net Income (Reported)	5,124	4,325	5,116	5,592
Recurring Net Income	3,673	4,325	5,116	5,960

Source: Company data, I-Sec Research

Table 7: Balance Sheet

(Rs mn, year ending March 31)

	FY09	FY10E	FY11E	FY12E
Assets				
Total Current Assets	27,026	29,363	33,074	38,802
of which cash & cash eqv.	1,926	5,135	5,989	8,669
Total Current Liabilities & Provisions	5,803	5,901	6,285	6,940
Net Current Assets	21,223	23,461	26,789	31,861
Investments	1,271	1,271	1,271	65
Net Fixed Assets	2,910	3,470	4,046	4,729
Goodwill	15,183	15,183	15,183	15,183
Total Assets	40,587	43,385	47,288	51,838
Liabilities				
Borrowings	5,757	5,257	5,257	5,257
Deferred Tax Liability	(113)	(113)	(113)	(113)
Minority Interest	948	977	1,012	1,054
Equity Share Capital	434	434	434	434
Face Value per share (Rs)	1.0	1.0	1.0	1.0
Reserves & Surplus*	33,561	36,831	40,699	45,206
Net Worth	33,995	37,264	41,132	45,640
Total Liabilities	40,587	43,385	47,288	51,838

Source: Company data, I-Sec Research

Table 10: Quarterly trends

(Rs mn, year ending March 31)

	Dec-08	Mar-09	Jun-09	Sep-09
Net sales	5,456	5,137	4,759	5,405
% growth (YoY)	5	(2)	(12)	(5)
EBITDA	1,200	1,202	1,170	1,508
Margin (%)	22	23	25	28
Other income	401	639	325	291
Add: Extraordinaries	(26)	(65)	-	-
Net profit	806	916	1,019	1,141

Source: Company data

Table 8: Cash Flow Statement

(Rs mn, year ending March 31)

	FY09	FY10E	FY11E	FY12E
Operating Cash flow	1,837	3,279	3,886	4,310
Working Capital Changes	(5,078)	1,243	(2,429)	(2,418)
Capital Commitments	788	(996)	(1,086)	(1,249)
Free Cash Flow	(2,454)	3,526	370	642
Cash flow from Investing Activities	1,495	1,210	1,697	3,079
Issue of Share Capital	0	-	-	-
Buyback of shares	-	(0)	-	-
Inc (Dec) in Borrowings	1,891	(500)	-	-
Dividend paid	(989)	(1,085)	(1,283)	(1,495)
Extraordinary Items	1,451	-	-	-
Chg. in Cash & Bank balance	274	3,209	854	2,679

Source: Company data, I-Sec Research

Table 9: Key Ratios

(Year ending March 31)

	FY09	FY10E	FY11E	FY12E
Per Share Data (in Rs.)				
Diluted Recurring EPS	8.5	10.0	11.8	13.7
Reported EPS	11.8	10.0	11.8	12.9
Recurring Cash EPS	9.2	11.0	13.0	15.1
Dividend per share (DPS)	2.0	2.2	2.6	3.0
Book Value per share (BV)	78.2	85.8	94.7	105.1
Growth Ratios (%)				
Operating Income	18.6	3.0	15.2	14.8
EBITDA	1.1	7.1	20.0	13.9
Recurring Net Income	(4.6)	17.8	18.3	16.5
Diluted Recurring EPS	(4.6)	17.8	18.3	16.5
Diluted Recurring CEPS	(2.5)	19.5	18.2	16.0
Valuation Ratios (x)				
P/E	26.8	22.8	19.2	16.5
P/CEPS	24.7	20.7	17.5	15.1
P/BV	2.9	2.6	2.4	2.2
EV / EBITDA	18.7	17.4	14.5	12.7
EV / Operating Income	4.7	4.6	4.0	3.4
EV / Operating FCF	(31.5)	22.6	70.2	54.1
Operating Ratio (%)				
Production cost/Sales	8.5	9.0	9.0	8.8
Other Income / PBT	29.1	25.9	24.1	23.3
Effective Tax Rate	23.8	33.0	33.0	35.4
NWC / Total Assets	47.5	42.2	44.0	44.7
Inventory Turnover (days)	NA	NA	NA	NA
Receivables (days)	103.5	102.4	93.4	93.5
Payables (days)	82.7	83.5	77.6	74.7
D/E Ratio (x)	0.17	0.14	0.13	0.11

Return/Profitability Ratio (%)

Recurring Net Income Margins	15.7	17.9	18.5	18.8
RoCE	8.7	7.3	8.3	13.0
RoNW	11.7	12.1	13.1	13.7
Dividend Payout Ratio	23.6	22.0	22.0	22.0
Dividend Yield	0.9	1.0	1.1	1.3
EBITDA Margins	25.2	26.2	27.3	27.1

Source: Company data, I-Sec Research

I-Sec investment ratings (all ratings relative to Sensex over next 12 months)

BUY: +10% outperformance; **HOLD:** -10% to +10% relative performance; **SELL:** +10% underperformance

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