

August 16, 2010

### HOLD

Price <b>Rs 168</b>	Target Price <b>Rs180</b>
<b>Sensex</b>	<b>18,167</b>

#### Price Performance

(%)	1M	3M	6M	12M
Absolute	(10)	15	(1)	(37)
Rel. to Sensex	(11)	9	(12)	(46)

Source: Bloomberg

#### Stock Details

Sector	Telecom
Reuters	RLCM.BO
Bloomberg	RCOM@IN
Equity Capital (Rs mn)	10320
Face Value (Rs)	5
No of shares o/s (mn)	2064
52 Week H/L (Rs)	320/132
Market Cap (Rs bn/USD mn)	347/7,416
Daily Avg Vol (No of shares)	11417505
Daily Avg Turnover (US\$ mn)	42.8

#### Shareholding Pattern (%)

	J'10	M'10	D'09
Promoters	67.7	67.6	67.5
FII/NRI	9.3	9.0	8.8
Institutions	9.3	9.7	9.6
Private Corp	2.6	2.4	2.8
Public	11.0	11.3	11.3

Source: Capitaline

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- Poor revenue & EBIDTA growth disappoint, interest exp. of Rs4.4bn (v/s income of Rs8.1bn previously) hit profits sharply
- Wireless traffic growth at just 0.8% QoQ v/s >10% QoQ for peers (Bharti & Idea) due to free minutes withdrawal
- Cut EBIDTA and EPS estimates by 12.6%/4.4% and 29.6%/21% for FY11E/12E respectively
- Cut target price to Rs180 (from Rs228) based on 7.2x FY11E residual biz EV/EBIDTA post tower hive-off

#### Revenue & EBIDTA stable, interest on increased net-debt hit profitability

Q1FY11 revenue flat at Rs51bn (v/s estimate of 3% growth) due to poor performance of wireless segment with just 1.6% QoQ growth v/s ~6% in case of Idea & Bharti affected by dismal mobile traffic growth of just 0.8%. Global business decline of 10.6% QoQ further impacted revenues. EBIDTA grew 1.9% QoQ to Rs16.3bn due to lower network costs. Interest cost of Rs4.4bn v/s gain in most quarters earlier, resulted in sharp profit swing with QoQ fall of 79.4% to Rs2.5bn (v/s consensus estimate of Rs5.6bn). Higher interest exp. on increased net-debt (from Rs199bn in Q4FY10 to Rs285bn) due to payment of 3G fees and forex loss of Rs2bn resulted in interest expense swing.

#### Wireless traffic growth dismal

Wireless business revenues grew by just 1.5% QoQ to Rs41.5bn v/s GSM peers who registered 6% QoQ growth. RCOM reported dismal traffic growth of just 0.8% QoQ v/s that of >10% with peers. RPM remained stable at Re0.44/minute due to withdrawal of free minutes which also was a reason for poor traffic growth. ARPU fell by 6.5% to Rs130 on MOU decline of 7.2% QoQ to 295 minutes.

#### Net debt rises sharply to 4x EBIDTA

Post the 3G auctions and payment of Rs85bn by RCOM for the same, the net-debt has risen sharply to Rs285bn – 4x FY11E EBIDTA. While high net-debt remains key concern with RCOM especially given the absence of revenue growth, the tower business hive-off could reduce the gearing considerably (net debt/EBIDTA from 4x now to below 3x post deal). We highlight that successful completion of tower deal with GTL Infra remains key risk to our positive stance on RCOM.

#### EBIDTA & EPS estimates cut by 12.6%/4.4% and 29.6%/21% for FY11E/12E

Considering below estimated Q1FY11 performance and poor & divergent revenue trend, we believe that RCOM continues to witness strong competitive headwinds and hence cut its revenue and EBIDTA estimates by 9.8%/9% and 12.6%/4.4% for FY11E/12E. Factoring higher net-debt and consequent increase in interest expense, we cut our EPS estimates by 29.6%/21% for FY11E/12E to Rs11.2/10.8.

#### Downgrade to HOLD with target price of Rs180 (from Rs228)

While we have cut our EPS estimates significantly, we believe that stock under performance has been ahead of poor show. We continue to value RCOM based on 7.2x residual EBIDTA post tower hive-off to GTL Infra resulting in target price of Rs180/share. RCOM based on cons. valuations looks expensive, however post tower deal valuations not only make valuations attractive but also reduce gearing from 4x to below 3x EBIDTA. Cut target price to Rs180 (from Rs228) and rating to HOLD.

#### Financial Snapshot

Rs Mn

Yr.	Net Sales	EBITDA (Core)	EBITDA (%)	PAT	EPS (Rs)	EPS % chg	ROE (%)	P/E (x)	EV/EBITDA	P/BV
FY09	229,411	92,875	40.5	51,285	24.8	0.4	19.7	7.0	6.3	1.0
FY10	222,502	78,869	35.4	35,555	17.2	-30.7	12.9	10.2	7.1	0.9
FY11E	216,388	69,789	32.3	23,197	11.2	-34.8	6.1	15.6	8.6	0.9
FY12E	230,771	74,383	32.2	22,374	10.8	-3.5	5.5	16.1	8.1	0.8

**EBIDTA estimate cut by 12.6% / 4.4% for FY11E/12E**

From Q1FY11 results we believe that RCOM along with new GSM players have begun getting affected by the incumbency factor with the traffic growth flowing back to the incumbent GSM operators such as Bharti & Idea. Considering RCOM's continued poor show and lack of recovery in wireless business, we cut our revenue projections by 9.8% and 9% for FY11E and FY12E respectively. While our EBIDTA estimates are cut by 12.6% /4.4% for FY11E/12E, we have cut EPS estimates by sharp 29.6% / 21% respectively due to sharp rise in net-debt to Rs285bn.

	FY10	FY11E			FY12E		
	Actual	Old	New	% Chg	Old	New	% Chg
Revenues	222,502	239,930	216,388	-9.8%	253,645	230,771	-9.0%
EBIDTA	78,869	79,850	69,789	-12.6%	77,814	74,383	-4.4%
EBIDTA %	35.4	33.3	32.3	-103	30.7	32.2	155
APAT	35,555	32,942	23,197	-29.6%	28,338	22,374	-21.0%
EPS	17.2	16.0	11.2	-29.6%	13.7	10.8	-21.0%

**Valuation of RCOM post tower hive-off to GTL Infra**

We value RCOM on the basis of 7.2x FY11E residual EBIDTA post the tower deal with GTL Infra. Our EV calculation for towers being hived-off by RCOM is at par with recent M&A deal between GTL Infra & Aircel (EV/tenant of Rs3.5mn and EV/ROFR of Rs0.5mn), and any premium would provide upside to RCOM. Considering the estimated EV of tower business at Rs317bn, the residual FY11E EBIDTA of Rs48.2bn implies FY11E EV/EBIDTA valuation of 6.5x, which we believe is reasonable.

RCom residual business valuation	FY10	FY11E	Remarks
Towers	50,000	52,000	
Tenants	87,000	95,000	Factoring increased tenancy
Avg rental (Rs)	27,500	27,500	Avg of GBT & RTT in the ratio 75:25
Revenue (Rs mn)	26,400	30,030	
EBIDTA (Rs mn)	18,480	21,622	
	70.0%	72.0%	Considered peak margins, lower EBIDTA transfer would result in higher residual EBIDTA, positive for RCOM
<b>Valuation of RCOM's tower biz</b>			
Tenants transferred	87,000		
ROFR – assumed	25,000		Assumed assurance of 25000 tenancy over 2-3 years
EV/Tenant (Rs mn)	3.5		In-line with GTL Infra-Aircel deal
EV/ROFR* (Rs mn)	0.5		In-line with GTL Infra-Aircel deal
EV of tower biz (Rs mn) (a)	317,000	317,000	
Implied EV/EBIDTA	17.2	14.7	Implied valuations
<b>RCOM residual biz valuation</b>			
RCOM cons. EBIDTA (Rs mn)	78,869	69,789	
Residual EBIDTA (Rs mn)	60,389	48,167	
Target EV/EBIDTA		7.2	At 10% discount to Bharti's valuation
Residual EV (Rs mn) (b)		346,805	
EV – Tower + residual (a + b)		663,805	
FY11E net debt (cons)		294,353	
Target Market cap		369,451	
Target price (Rs)		180	
CMP (Rs)		168	
Upside		7%	

Source: Emkay Research \* ROFR – Right of first refusal

**Failure of tower deal with GTL Infra - key risk to our call on the stock**

We believe that RCOM faces high balance sheet risks with gearing of 4x net-debt /EBIDTA and at the same time muted revenue show and absence of FCF generation limit scope for meaningful reduction in debt. However, the tower deal with GTL Infra, we believe, would significantly reduce the BS leverage and make valuations of RCOM attractive. Successful completion of the tower hive-off transaction with GTL Infra remains key downside risk to our stance on RCOM.

**Key Financials – Quarterly**

	1Q10	2Q10	3Q10	4Q10	1Q11	QoQ %
Wireless	47,931	40,100	40,225	40,900	41,528	1.5%
Global	18,844	22,643	19,818	20,278	18,137	-10.6%
Broadband	6,842	7,700	7,045	6,798	6,763	-0.5%
Others	3,031	2,760	3,160	2,845	3,348	17.7%
Gross Revenues	76,648	73,203	70,248	70,821	69,776	-1.5%
Inter segment	(15,196)	(16,178)	(17,150)	(19,894)	(18,684)	
<b>Net revenues</b>	<b>61,452</b>	<b>57,026</b>	<b>53,098</b>	<b>50,927</b>	<b>51,092</b>	0.3%
Access charges	4,811	4,772	5,501	6,294	6,610	5.0%
% of sales	7.8	8.4	10.4	12.4	12.9	
License fees	3,034	2,913	2,836	2,668	3,102	16.3%
% of sales	4.9	5.1	5.3	5.2	6.1	
Network expenses	13,856	15,919	16,708	15,251	13,079	-14.2%
% of sales	22.5	27.9	31.5	29.9	25.6	
Employee cost	4,112	3,816	3,677	3,396	3,535	4.1%
% of sales	6.7	6.7	6.9	6.7	6.9	
S,G & A	11,114	9,407	6,250	7,300	8,446	15.7%
% of sales	18.1	16.5	11.8	14.3	16.5	
Operating expenses	36,927	36,827	34,971	34,909	34,772	-0.4%
<b>EBIDTA</b>	<b>24,525</b>	<b>20,198</b>	<b>18,127</b>	<b>16,018</b>	<b>16,320</b>	1.9%
Depreciation	11,144	7,144	8,331	10,847	9,648	-11.1%
EBIT	13,381	13,055	9,796	5,171	6,672	29.0%
Extra ordinary	111	29	221	15	-	-100.0%
Interest charges	(6,205)	6,551	(4,076)	(8,134)	4,396	-154.0%
PBT	19,475	6,475	13,651	13,290	2,276	-82.9%
Tax	2,267	(1,739)	2,003	1,923	(719)	-137.4%
PAT before minority	17,208	8,214	11,648	11,367	2,995	-73.7%
Minority interest	842	811	568	(826)	486	-158.8%
<b>PAT</b>	<b>16,366</b>	<b>7,403</b>	<b>11,080</b>	<b>12,193</b>	<b>2,509</b>	-79.4%

% of sales	1Q10	2Q10	3Q10	4Q10	1Q11	Chg bps
EBIDTA	39.9	35.4	34.1	31.5	31.9	49
EBIT	21.8	22.9	18.4	10.2	13.1	290
PAT	26.6	13.0	20.9	23.9	4.9	(1,903)
ETR	11.6	(26.9)	14.7	14.5	(31.6)	

Operating matrix	1Q10	2Q10	3Q10	4Q10	1Q11	% QoQ
Wireless Subscribers ('000)	79,616	86,118	93,796	102,422	110,806	8.2%
ARPU (Rs)	210	161	149	139	130	-6.5%
MOU (minutes)	365	340	330	318	295	-7.2%
RPM (Re)	0.58	0.47	0.45	0.44	0.44	0.8%

Source: Company, Emkay Research

## Key Financials

## Income Statement

Rs Mn	FY09	FY10	FY11E	FY12E
<b>Net Sales</b>	<b>229,411</b>	<b>222,502</b>	<b>216,388</b>	<b>230,771</b>
<i>Growth (%)</i>	20.3	-3.0	-2.7	6.6
License & Access chg	35,682	32,828	40,351	38,077
<i>% to sales</i>	15.6	14.8	18.6	16.5
Network optng exp	43,642	61,734	60,170	70,323
<i>% to sales</i>	19.0	27.7	27.8	30.5
Personnel exp	16,702	15,001	15,751	16,145
<i>% to sales</i>	7.3	6.7	7.3	7.0
S, G & A	40,510	34,071	30,327	31,843
<i>% to sales</i>	17.7	15.3	14.0	13.8
<b>EBITDA</b>	<b>92,875</b>	<b>78,869</b>	<b>69,789</b>	<b>74,383</b>
Depreciation	39,314	37,465	36,974	39,764
<b>EBIT</b>	<b>53,561</b>	<b>41,404</b>	<b>32,815</b>	<b>34,619</b>
Interest	(7,867)	(11,863)	5,370	6,120
<b>PBT</b>	<b>61,429</b>	<b>53,267</b>	<b>27,445</b>	<b>28,499</b>
Taxes	(123)	4,453	3,281	5,193
<b>APAT</b>	<b>61,551</b>	<b>48,813</b>	<b>24,163</b>	<b>23,306</b>
Extra ordinary	75	375	0	0
<b>APAT before MI</b>	<b>61,476</b>	<b>48,438</b>	<b>24,163</b>	<b>23,306</b>
Minority interest	(2,399)	(1,395)	(967)	(932)
<b>APAT after MI</b>	<b>59,077</b>	<b>47,044</b>	<b>23,197</b>	<b>22,374</b>
<b>Growth %</b>	<b>9.4</b>	<b>-20.4</b>	<b>-50.7</b>	<b>-3.5</b>

## Balance Sheet

	FY09	FY10	FY11E	FY12E
Equity Capital	10,320	10,320	10,320	10,320
Reserves & surplus	359,683	377,505	399,616	420,507
<b>Net worth</b>	<b>370,003</b>	<b>387,825</b>	<b>409,936</b>	<b>430,827</b>
Minority interest	8,228	7,472	7,472	7,472
Total Debt	335,520	247,473	347,473	347,473
<b>Capital Employed</b>	<b>713,751</b>	<b>642,770</b>	<b>764,881</b>	<b>785,772</b>
<b>Gross Block</b>	<b>756,489</b>	<b>786,643</b>	<b>856,643</b>	<b>910,643</b>
Less Depreciation	141,069	190,765	227,739	267,503
<b>Net Fixed Assets</b>	<b>615,420</b>	<b>595,878</b>	<b>628,904</b>	<b>643,140</b>
CWIP	114,056	119,517	180,367	181,987
Investments	2,857	1,199	1,199	1,199
<b>Current assets</b>				
Inventory	5,427	5,446	5,039	5,058
Debtors	54,785	33,920	32,606	34,774
Cash and Bank	109,577	48,585	53,120	50,490
Other CA	76,771	76,201	77,070	75,870
<b>Total Cur. assets</b>	<b>246,560</b>	<b>164,152</b>	<b>167,835</b>	<b>166,191</b>
Current Liab. & prov	265,142	237,976	213,424	206,745
<b>Net Cur. assets</b>	<b>(18,582)</b>	<b>(73,824)</b>	<b>(45,589)</b>	<b>(40,554)</b>
<b>Capital Deployed</b>	<b>713,751</b>	<b>642,770</b>	<b>764,881</b>	<b>785,772</b>

## Cash Flow Statement

	FY09	FY10	FY11E	FY12E
EBIT	53,561	41,404	32,815	34,619
Depreciation	39,314	37,465	36,974	39,764
Interest (Net)	7,867	11,863	(5,370)	(6,120)
Tax Paid	123	(4,453)	(3,281)	(5,193)
Change in WC	(16,353)	(5,750)	(23,700)	(7,665)
Others	(75)	(375)	0	0
<b>CFO</b>	<b>84,437</b>	<b>80,154</b>	<b>37,437</b>	<b>55,405</b>
Net Capex	(258,578)	(35,615)	(130,850)	(55,620)
<b>FCF</b>	<b>(174,141)</b>	<b>44,539</b>	<b>(93,413)</b>	<b>(215)</b>
Others	20,109	21,361	0	0
<b>CFI</b>	<b>20,109</b>	<b>21,361</b>	<b>0</b>	<b>0</b>
Equity Issue	0	0	0	0
Net Borrowings	119,839	(88,047)	100,000	0
Dividend paid	(1,811)	(1,932)	(2,052)	(2,415)
others	29,600	(36,913)	0	0
<b>CFF</b>	<b>147,628</b>	<b>(126,891)</b>	<b>97,948</b>	<b>(2,415)</b>
Inc/(dec) in cash	(6,404)	(60,992)	4,535	(2,630)
Opening Cash	115,981	109,577	48,585	53,120
Closing Cash	109,577	48,585	53,120	50,490

## Ratios

	FY09	FY10	FY11E	FY12E
<b>Profitability (%)</b>				
EBITDA %	40.5	35.4	32.3	32.2
EBIT %	23.3	18.6	15.2	15.0
NPM %	26.8	21.9	11.2	10.1
ROCE %	8.9	6.1	4.7	4.5
ROE %	19.7	12.9	6.1	5.5
ROIC %	10.9	6.9	5.0	4.8
<b>Per Share Data (Rs)</b>				
AEPS	24.8	17.2	11.2	10.8
Cash EPS	48.9	41.8	29.6	30.6
Book Value	179	188	199	209
Div per share	1.6	1.7	2.0	2.0
<b>Valuations (x)</b>				
PE (x)	7.0	10.2	15.6	16.1
Cash PE (x)	3.6	4.2	5.9	5.7
P/BV (x)	1.0	0.9	0.9	0.8
EV/Sales (x)	2.5	2.5	2.6	2.4
EV/EBITDA	6.3	7.1	8.6	8.1
<b>Gearing Ratio (x)</b>				
Net Debt /Equity	0.6	0.5	0.7	0.7
Net Debt /EBIDTA	2.4	2.5	4.2	4.0

**Recommendation History: Reliance Communications – RCOM IN**

Date	Reports	Reco	CMP	Target
28.06.2010	<a href="#">Reliance Communication Event Update</a>	Accumulate	201	228
03.02.2010	<a href="#">RCOM 3QFY10 Result Update</a>	Reduce	170	152
03.09.2009	<a href="#">RCOM Company Update</a>	Hold	276	303
03.08.2009	<a href="#">RCOM 1QFY10 Result Update</a>	Hold	276	250

**Recent Research Reports**

Date	Reports	Reco	CMP	Target
03.08.2010	<a href="#">DB Corp Q1FY11 Result Update</a>	Accumulate	248	284
02.08.2010	<a href="#">Jagran Prakashan Q1FY11 Result Update</a>	Buy	121	155
29.07.2010	<a href="#">HT Media Q1FY11 Result Update</a>	Hold	158	159
26.07.2010	<a href="#">Idea Cellular Q1FY11 Result Update</a>	Sell	69	60

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