

Bharti Airtel

Rs417
OUTPERFORMER

Event update

Mkt Cap: Rs1581bn; US\$33bn

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Media reports on the ongoing Bharti-MTN negotiations suggest that the demand for a higher price by some large MTN shareholders could be a potential roadblock in culmination of the deal in its present form. Mr Sunil Mittal, in a recent press interview, has stated that Bharti is not really keen on sweetening the deal. We believe the proposed transaction benefits Bharti by way of geographic diversification through MTN's strong presence across 21 countries in the African and the Middle-East regions. While underpenetration in some of these markets offers high growth potential, MTN's robust profitability metrics as well as positive FCF stack up well against that of Bharti. The negotiations, however, have been rather stretched presumably due to the need to ensure compliance with regulations extant in each of the geographies where MTN is present as well as to mull over the demand for a higher offer price by some public shareholders of MTN. This is especially relevant given the need for securing a 75% voting majority of MTN shareholders for the deal to go through. Further, clarity also needs to emerge on an appeal filed against the SEBI order exempting MTN from making an open offer to Bharti shareholders as also on the RBI's stance as regards the relaxed FDI norms. Thus, while MTN's implied valuations for the proposed deal at EV/EBIDTA of 6.6x 2008 EBIDTA appear reasonable, potential risks remain in the form of a significant sweetening in Bharti's offer price for MTN as also with the regulatory stance mandating an open offer by MTN to Bharti shareholders. Bharti at CMP trades at PE of 15.9x and EV/EBIDTA of 8.7x FY11E. Maintain Outperformer with target price of Rs445.

□ Background

Bharti Airtel (Bharti), in May 2009, announced that it had renewed its effort for a potential transaction with South Africa's MTN Group, whereby, through a scheme of arrangement, Bharti would acquire 49% shareholding in MTN. In turn, MTN and its shareholders would acquire ~36% economic interest in Bharti (25% to be held by MTN). The proposed deal structure involves cash consideration and issue of new stock/ GDRs by both the entities aggregating to ~\$23bn both ways. The broader strategic objective of the deal is to eventually achieve a full merger between MTN and Bharti, with the combined entity having revenues of ~\$20bn and a subscriber base of ~200m. Bharti and MTN had originally agreed to an exclusivity period until 31 July 2009. Subsequently, both parties extended the timeline on two occasions and the exclusivity period currently ends on 30 September 2009.

□ Contours of the deal

- Bharti would acquire ~36% of the outstanding share capital issued of MTN from MTN shareholders for a consideration comprising 86ZAR (US \$10.4) in cash and 1 newly issued Bharti share (adjusted for 1:1 split) in the form of GDRs for every MTN share acquired. Each GDR would be equivalent to one share of Bharti to be listed on the Johannesburg Stock Exchange, South Africa. Total cash consideration works out to \$7bn while the value of Bharti's stock issued to MTN and its shareholders comes to \$6bn.
- MTN would buy a 25% post-transaction economic interest in Bharti through a fresh issue of shares by Bharti. The consideration for this purchase would be ~\$2.9bn in cash and newly issued shares of MTN equal to ~25% of the pre-transaction equity capital of MTN. By virtue of these new shares issued by MTN, Bharti's shareholding in MTN would rise from 36% to ~49%. Net cash outflow for Bharti as a result would come down to \$4.1bn (i.e. from \$7bn to \$2.9bn).

- The deal values MTN's equity at \$33bn (\$16.2bn for a 49% stake), implying an EV of ~\$35bn. MTN's implied 2008 EV/EBIDTA of 6.6x compares with Bharti's pre-deal valuation of 11x FY09 EV/EBIDTA. MTN's profitability metrics (EBIDTA margin of 41% and RoCE of 27% in 2008) are comparable to that of Bharti. MTN had a net gearing of 0.2x as of December 2008 and generated FCF of \$1.2bn in 2008. Based on these metrics, the proposed transaction appears to be reasonably valued.

Exhibit 1: Contours of the proposed transaction

Particulars	%
Dilution in Bharti's outstanding equity capital	57
Dilution in MTN's outstanding equity capital	25
Bharti's post transaction stake in MTN	49
Post transaction stake held by MTN in Bharti	25
Stake held by MTN shareholders in Bharti through GDRs	11
Total MTN+MTN's shareholders	36
Cash paid by Bharti to MTN's shareholders (\$ bn)	7.0
Less: Cash received by Bharti from MTN (\$ bn)	2.9
Net cash outflow for Bharti (\$ bn)	4.1

Source: Company release, IDFC-SSKI Research

Exhibit 2: MTN's equity valued at \$33bn

Particulars	\$bn
Cash paid to MTN's shareholders	7.0
Value of 36% stake issued to MTN and its shareholders	12.1
Less: cash received	2.9
Net Value paid for 49% stake	16.2
Equity valuation of the deal (for 100%)	33
Net Debt (2008)	1.6
EV	35
EBIDTA (2008)	5.2
EV/EBIDTA	6.6

Source: IDFC-SSKI Research, Bloomberg estimates

□ Rationale behind the deal

Bharti stands to gain through diversification into some relatively under-penetrated and less competitive markets as MTN is in a position of strength in these markets. Typically, there are 3-5 players in each of MTN's markets and MTN is one of the top two players in all these markets. MTN management has guided for a subscriber base of 113m in December 2009, implying growth of 25%. With the Indian market set to turn fiercely competitive as several new players join the fray, Bharti's proposed diversification strategy appears well-timed. Further, valuations too appear reasonable considering MTN's high profitability levels and cash flows, and that Bharti will have management control of the merged entity.

Exhibit 3: MTN Group – operational data

	Dec-06	Dec-07	Dec-08	Mar-09*
Total subscribers (m)	40	61	91	98
Proportionate subscriber base (m)	35	50	70	76
Regional composition (%)				
South and East Africa	39	31	27	26
West and Central Africa	49	46	44	45
Middle-East and North Africa	12	23	29	29
Regional ARPU Trend (\$)				
South and East Africa	22	19	16	14
West and Central Africa	18	16	15	11
Middle-East and North Africa	15	13	10	9

Source: Company reports * -regional ARPUs for Mar-09 are estimates

Exhibit 4: MTN has strong profitability metrics

Particulars (%)	2008	2007	2006	2005
Gross margin	67.5	67.1	69.1	62.6
Sales growth	40.2	41.8	78.0	21.5
Net Inc growth	44.4	(0.0)	65.6	46.6
EBIDTA margin	43.9	43.9	43.2	40.6
Operating margin	31.5	31.7	31.0	31.2
Pretax margin	27.8	26.9	28.5	30.4
Effective tax rate	39.9	39.5	17.6	17.0
Profit margin	14.9	14.5	20.6	22.1
Return on assets	10.7	10.0	16.8	24.8
Return on equity	24.8	24.7	38.8	49.2
Return on cap.	27.0	18.7	30.4	41.9

Source: Bloomberg data, IDFC-SSKI Research

Exhibit 5: Key financials of MTN Group

(m USD)	Dec 08 A	Dec 07 A	Dec 06 A	Mar 05 A	Mar 04 A
Income statement					
Turnover	12,417	10,373	7,623	4,637	3,335
EBITDA	5,452	4,558	3,296	1,882	1,239
Operating profit (loss)	3,906	3,285	2,363	1,448	932
Pretax income	3,450	2,795	2,170	1,410	850
Income before XO items	2,075	1,690	1,788	1,170	696
Net profit (loss)	1,855	1,504	1,568	1,025	611
Basic EPS before Abnormal Items (\$)	1.0	0.8	NA	NA	NA
Basic EPS (\$)	1.0	0.8	0.9	0.6	0.4
Diluted EPS (\$)	1.0	0.8	0.9	0.6	0.4
Dividends per share (\$)	0.0	0.1	0.1	NA	NA
Return on common equity (%)	25	25	39	49	32
Balance sheet					
Total current assets	5,820	4,882	2,953	1,705	1,370
Total long-term assets	12,251	11,963	10,916	3,001	2,161
Total assets	18,071	16,846	13,869	4,706	3,531
Total current liabilities	5,800	5,097	2,860	1,200	1,008
Total long-term liabilities	3,715	4,243	4,895	580	694
Total liabilities	9,515	9,340	7,755	1,780	1,701
Total shareholders' equity	8,556	7,506	6,115	2,926	1,830
Shares outstanding (m)	1,868	1,865	1,860	1,660	1,654
Book value per share (\$)	4.3	3.7	3.0	1.5	1.0
Tangible book value per share (\$)	1.7	0.7	(0.1)	1.4	0.8
Equity ratio (%)	47	45	44	62	52
Cash flows					
Operating profit (loss)	1,855	1,504	1,568	1,025	611
Cash from operating activities	4,453	3,904	2,764	1,628	1,201
Cash from investing activities	(3,291)	(2,432)	(5,704)	(1,208)	(684)
Cash from financing activities	55	(544)	2,646	(237)	(56)
Net changes in cash	1,217	927	(294)	184	461
Free Cash Flow	1,196	1,853	1,378	417	496
Free cash flow per basic share (\$)	0.6	1.0	0.8	0	0
Free cash flow per diluted share (\$)	0.6	1.0	0.8	NA	NA
Cash flow per share (\$)	2.4	2.1	1.6	1.0	0.7

Source: Bloomberg data

□ Impact of the deal on Bharti's earnings and the extent of equity dilution

- The proposed transaction would lead to ~57% dilution in Bharti's equity capital and 25% in that of MTN. While Bharti would have a net outflow of \$4.1bn, MTN's net debt too would rise by \$2.9bn (given that the cash paid by Bharti is to MTN's shareholders).
- Based on our FY10 and FY11 estimates for Bharti and consensus estimates for MTN (source: Bloomberg), we estimate the proposed deal to be marginally earnings-dilutive or at best earnings-neutral for Bharti in FY10.
- We have considered the consolidation impact of MTN H2FY10 onwards only. We estimate EPS of \$1.04 in FY10 and \$1.15 in FY11 for the merged entity (based on the weighted average number of shares).

Exhibit 6: Estimate the deal to be earnings neutral in FY10 (only H2 consolidation)

Year ended (\$ m, 1USD=Rs48)	FY09	FY10	FY11
Revenues			
Bharti	7,700	8,807	9,665
MTN	12400	7099	16111
Bharti+MTN	20100	15906	25776
EBIDTA			
Bharti	3160	3588	3856
MTN	5200	2959	6706
Bharti+MTN	8360	6547	10562
PAT			
Bharti	2013	1965	2069
Less: Additional Interest expense on Bharti	0	144	287
Add: PAT of MTN (49% stake)	0	709	1636
Bharti+MTN	2013	2530	3419
EPS (\$)			
Bharti's EPS	0.5	0.52	0.55
MTN's EPS	1.0	0.6	1.4
Bharti+MTN EPS		0.52	0.57
Change from current estimates (%)		0.2	5.3
Bharti's current no. of shares (m)	3,794	3,794	3,794
Bharti's post deal no. of shares (m)		5,956	5,956
Weighted average shares (m)		4,875	5,956

Source: IDFC-SSKI Research, Bloomberg consensus estimates

□ Potential roadblocks

75% voting majority requirement by MTN shareholders may lead to sweetening of Bharti's offer

South African regulations require acceptance of a proposed merger offer by 75% of the shareholders that are present and voting at a specially-conveyed meeting for approving the transaction. MTN's public shareholding stood at 74.7% as of December 2008 with the remaining 25.3% shares held by employees (through Newshelf Ltd)/ directors and Lombardier Odier (10.2%). Lebanon based Mikati family owns 9.8% and South African government owned Public Investment Corp (PIC) holds an 11.2% stake in MTN. Excluding PIC, the top five institutions (by shareholding) hold a total of ~22% of MTN shares. According to media reports, while MTN's non-public shareholders (25.3%) are in favour of the transaction, some institutional shareholders have expressed reservations or have demanded a higher offer price.

Exhibit 7: MTN Group's shareholding

MTN's shareholding (%)	Dec-08	Leading public shareholders (%)	Jun-09
Public	74.7	Alpine Trust	13.23
Non-public	25.3	Public Investment corp	11.17
of which		Mikati Family	9.82
Directors of MTN Group	0.2	Capital Research	3.02
Lombard Odier Darier Hentsch & Cie	10.2	Old Mutual	2.55
Newshelf (employee trust)	14.9	Fidelity	1.84
		Allan Gray	1.51

Source: Company reports, Bloomberg data

Regulatory overview – M&A norms specific to the transaction

South African regulations specify a scheme of arrangement in terms of section 311 of the Companies Act as one of the mechanics of acquisition. As per the regulations, the scheme of arrangement involves a court-sanctioned process which requires the acceptance and support of the target company as also acceptance of the offer by 75% of the scheme members present and voting at the duly-conveyed scheme meeting. Once the approvals have been obtained, the court will be required to sanction the scheme. Once the scheme becomes unconditional, the shares of all the scheme members will be acquired regardless of whether they voted in favour of, abstained from voting or voted against the scheme. The regulations do not specify any mandatory open offer requirement for this mode of acquisition.

Threat of SAT ruling against SEBI's open offer exemption granted to MTN

An individual investor in Bharti has filed an appeal with the Securities Appellate Tribunal (SAT) against SEBI's order which exempts MTN from making an open offer to Bharti's shareholders if a merger between the two materializes. SEBI's exemption was based on the proposed scheme that MTN's stake in Bharti would be held through GDRs and that an open offer would only be triggered once the GDRs are converted into regular shares with voting rights. SAT has scheduled the hearing in this case on 28 August 2009. In case SAT rules against SEBI's order, it could mandate an open offer by MTN and raise the overall deal consideration.

RBI's stance on relaxation in FDI norms in February 2009

As per Bharti's current shareholding, the total direct foreign shareholding stands at ~42% (FII holding of ~19.6%). With MTN and its shareholders likely to hold a 36% stake in Bharti Airtel post the transaction, the total direct foreign holding on the expanded equity base would increase to ~63%, which would be well within the FDI limit of 74% in the telecom sector. This computation, however, does not include the indirect foreign holding in Bharti Airtel by Singtel (14.9%) and Vodafone (4.4%) through Bharti Telecom and Bharti Enterprises respectively in light of the proposed relaxation in FDI norms issued through Press Note 2 in February 2009. According to this note, any foreign investment through an investing Indian company would not be considered as FDI if the investing Indian company is 'owned and controlled' by resident Indian citizens. 'Ownership' for this purpose is defined as >50% equity interest and 'controlled' is defined as the power to appoint a majority of the directors in the investing company. Both Bharti Telecom and Bharti Enterprises by this definition would be classified as Indian companies, and thus any foreign holding in these investing companies would not construe as FDI as per the Press Note 2. Media reports, however, cite that the Reserve Bank of India has expressed reservations on these proposed relaxations as they can potentially render all sectoral FDI caps meaningless. In the event these relaxed norms are not accepted, the proposed deal could encounter the FDI limit hurdle.

Exhibit 8: Computation of changes in ownership pattern post the proposed Bharti-MTN deal

Ownership (%)	Existing base	Expanded base
Outstanding equity shares (m)	3,797	5,955
Bharti Telecom	45	29
Existing foreign ownership	42	27
MTN+shareholders ownership	0	36
Total direct foreign holding	42	63
Indirect foreign holding		
Singtel	14.9	9.5
Vodafone	4.4	2.8
Total indirect foreign holding	19.2	12.3
Total direct+indirect foreign holding	61	75
Singtel's Effective stake	30.4	19.4
Vodafone's effective stake	4.4	2.8

Source: IDFC-SSKI Research

□ Valuations & View – maintain Outperformer

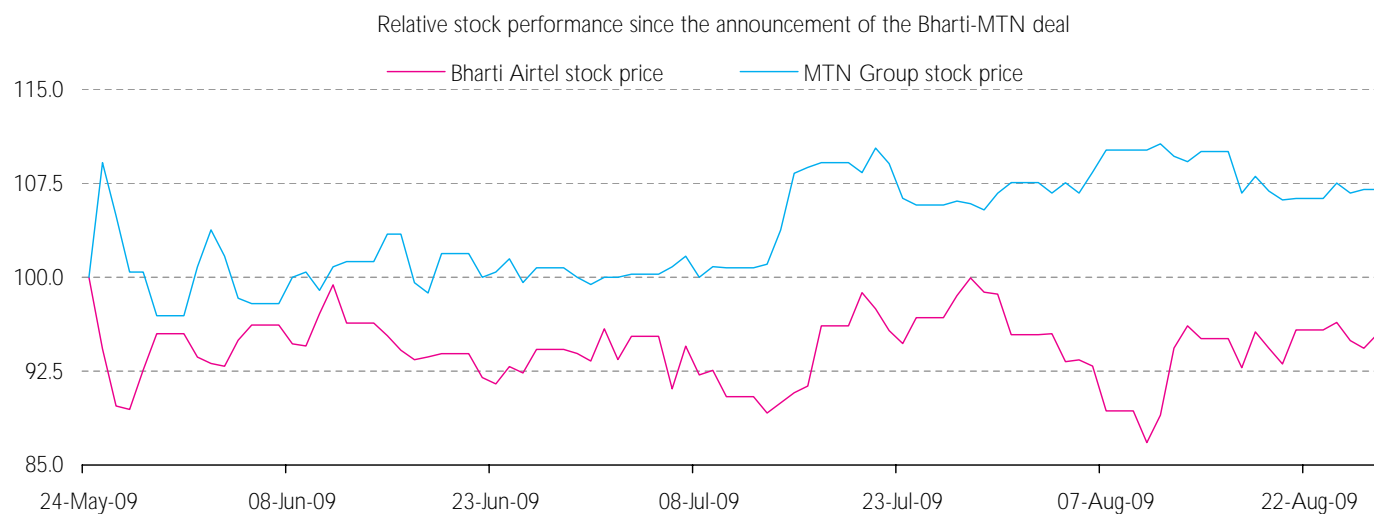
Bharti, given its incumbency advantage and ability to compete effectively, is best placed to weather competitive headwinds and defend its turf. While we expect an EBIDTA CAGR of 10.5% for Bharti (6.4% CAGR drop in wireless EBIDTA/ min), earnings growth is likely to remain capped (1.4% CAGR over FY09-11E; 6.4% CAGR ex-3G costs) due to higher depreciation and interest charges. The stock currently trades at 15.9x FY11E earnings and 8.7x EV/EBIDTA. Though we believe the deceleration in earnings growth and rising competition would cap a valuation rebound to historic peaks (currently in mid-range), Bharti's inherent business strengths and high visibility on FCF also restrict downside to the stock price. We have an Outperformer rating on Bharti with a DCF-based price target of Rs445. Key risks include predatory competition exerting further pressure on margins and a sharp increase in MTN's valuations for the proposed Bharti-MTN deal.

Exhibit 9: Key financials

As on 31 March	FY07	FY08	FY09	FY10E	FY11E
Net sales (Rs m)	185,195	270,250	369,615	422,719	463,906
Adj. net profit (Rs m)	41,779	67,184	96,622	94,313	99,321
Shares in issue (m)	3,792	3,796	3,796	3,797	3,797
Adj. EPS (Rs)	11.0	17.7	25.5	24.8	26.2
% change	75.7	60.6	43.7	(2.4)	5.3
PE (x)	37.8	23.5	16.4	16.8	15.9
Price/ Book (x)	11.5	7.0	5.0	3.6	2.9
EV/ EBITDA (x)	21.8	14.3	11.0	9.5	8.7
RoE (%)	36.3	37.0	35.8	25.0	20.4
RoCE (%)	27.9	28.3	26.4	21.8	18.2

Source: IDFC-SSKI Research

Exhibit 10: Relative stock performance: Bharti's stock is down 4.5%, MTN is up 7.0% post announcement of the deal



Source: IDFC-SSKI Research

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