

Company

27 June 2010 | 7 pages

Reliance Communications (RLCM.BO)

 Equity

Towerco Sale – Good for the Balance Sheet but Priced In

- Tower sale...finally** — RCOM announced plans to demerge its tower assets into GTL Infrastructure. The US\$11bn deal value for the 80k towers imputes EV/Tower of US\$138k. This is higher than recent deal benchmarks (~US\$100k), but far lower than the market-peak PE round (US\$229k/tower). The transaction involves a mix of cash infusion into RCOM and a share swap for RCOM and Reliance Infratel's minority shareholders though exchange ratios and cash/share split have yet to be finalized.
- Deal value higher than our gross towerco value** — The deal values RCOM's towers at US\$6.9bn, higher than our gross tower value. We currently value Reliance Infratel at Rs40 per RCOM share based only on the incremental value accretion to RCOM after netting off the cash cost contribution from the captive RCOM tenancy.
- Tower rental costs reduce RCOM consol EBITDA** — The incremental tower rentals (net of pass thru) will likely result in a 30% reduction of wireless EBITDA and 20% at the consol level assuming ROAs similar to those currently being seen at Indus/Infratel. The incremental tower rental costs (post deal) are broadly equal to the pre-deal depreciation plus interest on the cash received, leaving the transaction earnings neutral year one.
- Helps deleverage balance sheet though** — We estimate a cash infusion of ~Rs161bn (US\$3.4bn) assuming a 50:50 cash/stock split for the deal, which will substantially reduce balance sheet gearing. Overall FY11E net debt (incl 3G) will fall from Rs320bn to a more manageable Rs158bn with post-deal net debt/EBITDA at 2.6x versus 4x pre-deal.
- Maintain Sell** — RCOM currently trades at a pre-deal FY11E EV/EBITDA of 9.0x (post deal too at 9x) i.e., at a premium to Bharti. The company further plans to sell a 26% stake in the core business, which carries upside risks.

Sell/Medium Risk	3M
Price (25 Jun 10)	Rs192.50
Target price	Rs160.00
Expected share price return	-16.9%
Expected dividend yield	0.8%
Expected total return	-16.1%
Market Cap	Rs397,325M US\$8,623M

Price Performance (RIC: RLCM.BO, BB: RCOM IN)



Statistical Abstract

Year to	Net Profit	Diluted EPS	EPS growth	P/E	P/B	ROE	Yield
31 Mar	(RsM)	(Rs)	(%)	(x)	(x)	(%)	(%)
2008A	55,097	26.69	70.8	7.2	1.4	22.3	0.4
2009A	61,477	29.79	11.6	6.5	0.9	17.2	0.5
2010E	38,699	18.75	-37.1	10.3	0.9	8.8	0.8
2011E	37,226	18.04	-3.8	10.7	0.8	7.8	1.0
2012E	43,224	20.94	16.1	9.2	0.8	8.5	1.0

Source: Powered by dataCentral

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Figure 1. Wireless will have to pay lease rentals to the towerco

	Rs m
Number of towers	50000
Internal tenancy	1.50
External tenancy	0.25
Towerco EBITDA (based on Indus's rentals)	21,000
Capex recovery to be paid by the core business	18,000
RoA/tower/tenant	8.6%

Source: Citi Investment Research and Analysis

Figure 2. Consol EBITDA reduced by 20% after netting off tower hive-off

Rs m	FY10	FY11E
RCOM's wireless revenues	169,156	168,265
Wireless EBITDA	55,981	52,188
Adj Wireless EBITDA	37,981	34,188
Consol EBITDA	78,868	79,308
Adj consol EBITDA	60,868	61,308

Source: Citi Investment Research and Analysis

Figure 3. Stock (pre-deal/post deal) trading at premium to larger GSM incumbents

	FY10	FY11E
Cash infusion (Rs m)	161,563	161,563
Pre-deal EV/EBITDA (x)	8.1	9.0
Post-deal EV/EBITDA (x)	7.8	9.0
Net debt/EBITDA (x)	3.0	4.0
Post-deal Net debt/EBITDA (x)	1.3	2.6

Source: Citi Investment Research and Analysis estimates

Reliance Communications

Company description

RCOM is an integrated player in the Indian telecoms sector. It was listed on the Indian stock exchanges following the de-merger of Reliance Industries. RCOM is the second-largest player in the mobile segment, has an 80,000km-long India-wide optic-fiber network and owns the FLAG submarine cable network. RCOM has three business units: 1) Wireless, which includes a nationwide wireless network on CDMA and GSM; 2) Global Business comprising wholesale voice and data; and 3) Broadband for both retail and enterprise.

Investment strategy

We rate RCOM Sell/Medium Risk. While RCOM was able to show early signs of success in its GSM foray in 1Q, traffic growth has slowed down post other new launches, esp. DoCoMo. Recent tariff cuts make it susceptible to EBITDA and earnings decline as incumbents have matched the tariffs and leave RCOM's BS exposed, especially given high leverage (Net Debt/EBITDA of 3.7x FY10E). Besides RCOM's sub base is more susceptible to churn/traffic migration given high proportion of "scheme-hunting subs" and new entrants focus on the same

set of subs. While Reliance Infratel has been signing up new tenants, its dependence on start-ups for tenancy raises question marks on their viability given the worsening competitive scenario.

Valuation

Our target price of Rs160 comprises (i) core business value of Rs120 based on 6.0x FY11E EV/EBITDA, at 10% discount to Bharti's implied target multiple (ex- towerco) plus (ii) Infratel value accretion of Rs40 based on long-term tenancy of 2.3. We believe some discount to Bharti is justified on account of the inherent risks of dual network, higher leverage, stretched FCF breakeven, and lack of clarity and consistency on accounting policies (especially related to finance income). Our towerco net value accretion of Rs40 is based on the following assumptions: 1) Long-term tenancy of 2.3 with captive tenancy of 1.6; 2) Capex recovery of 13%, 3) WACC of 11.3% and terminal growth rate of 3%; 4) Please note that the incremental value accretion to RCOM is calculated after netting off the contribution from the captive tenancy. Thus, it only reflects the value of the external revenues.

Risks

Our risk-rating system, which tracks 260-day share price volatility, assigns a High Risk rating to RCOM. We however assign Medium Risk rating given the improvement in the B/S and the credit markets. Upside risks to our target price include higher-than-expected market share gains in GSM and visibility on tenancy of RTIL with possible move towards value monetization. Easing of the macro credit environment and slower conversion of current liabilities to real debt would positively impact the earnings and sentiment on the stock.

Appendix A-1

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Covered since June 18 2010

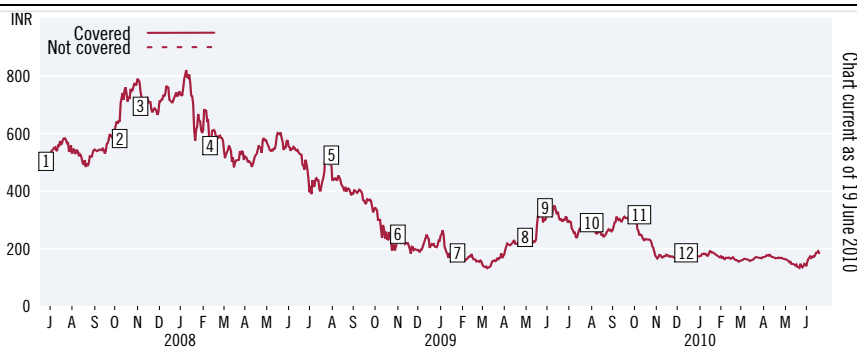


Chart current as of 19 June 2010

	Date	Rating	Target Price	Closing Price
1	20-Jun-07	1M	*600.00	505.90
2	8-Oct-07	*1L	*750.00	640.90
3	6-Nov-07	*2L	*835.00	745.40
4	12-Feb-08	*1L	*760.00	575.70

	Date	Rating	Target Price	Closing Price
5	31-Jul-08	*2L	*530.00	500.05
6	2-Nov-08	*2H	*270.00	220.70
7	26-Jan-09	*3H	*150.00	160.15
8	30-Apr-09	3H	*190.00	214.95

	Date	Rating	Target Price	Closing Price
9	28-May-09	3H	*270.00	297.35
10	2-Aug-09	*2M	*310.00	275.65
11	8-Oct-09	*3M	*210.00	246.30
12	12-Dec-09	3M	*160.00	183.65

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

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