Company Flash

25 June 2008 | 10 pages

IDEA Cellular (IDEA.BO)

Spice Deal: Good for Balance Sheet, Neutral for Valuations, but What About New Circle NAVs?

- **Idea acquires Spice...finally –** It's in three distinct steps: i) Modis stake (40.8%) to be sold to Idea at Rs77 (financed by TM); ii) Open offer for 20% to Spice's minorities at Rs77; and iii) merger of Spice into Idea with TMI's residual stake of 39.2% being swapped into Idea shares in the ratio of 0.49:1.
- **Net cash +ve deal for Idea, balance sheet ready for expansions (and 3G?) –** Idea will make a preferential allotment of 15% stake post-issue (@Rs157) to TMI, i.e. Rs73bn. Idea will pay Rs38bn for Spice acquisition (incl. all of open offer +non-compete fee), leaving Rs35bn as net cash inflow. This, coupled with the recent US$640m Providence deal, makes Idea well capitalized for the upfront capex in 7 new rollouts (US$700-800m) + the cash burn for 18-24 months.
- **Valuation premium from TM makes it neutral for Idea** – Spice at Rs77 and Idea at Rs157 translate to similar FY09E EV/EBITDA of ~16.5x, implying that acquisition is valuation neutral despite seemingly high premiums and notwithstanding the differences in towerco rental accounting by Spice. If TM participates in the open offer, it would help Idea further, albeit marginally.
- **Question marks –** 1) Extent of open offer funding by TMI; TMI's stake will be ~19.0% in base case; 2) Post-merger, six licenses may be surrendered; but refund process (Rs8.4bn) is unclear; 3) Non-compete fee, though within 25% regulated limit, may be perceived as minority unfriendly; and 4) Idea's ability to generate +ve NPV from the seven new circles, given its premium valuations.

Buy/Low Risk	1L
Price (25 Jun 08)	Rs97.70
Target price	Rs140.00
Expected share price return	43.3%
Expected dividend yield	0.0%
Expected total return	**43.3%**
Market Cap	Rs257,475M US$6,021M

Price Performance (RIC: IDEA.BO, BB: IDEA IN)

Statistical Abstract

Year to 31 Mar	Net Profit (RsM)	Diluted EPS (Rs)	EPS growth (%)	P/E (x)	P/B (x)	ROE (%)	Yield (%)
2006A	1,683	0.74	636.7	131.2	33.9	30.9	0.0
2007A	5,022	1.94	160.0	50.4	11.6	35.5	0.0
2008E	10,261	3.89	101.0	25.1	7.3	36.0	0.0
2009E	12,163	4.62	18.5	21.2	5.4	29.4	0.0
2010E	14,267	5.41	17.3	18.0	4.2	26.2	0.0

Source: Powered by dataCentral

Rahul Singh[1]
+91-22-6631-9863
rahul.r.singh@citi.com

Gaurav Malhotra, CFA[1]
gaurav.a.malhotra@citi.com

Anand Ramachandran, CFA[2]
+852-2501-2448
anand.ramachandran@citi.com

See Appendix A-1 for Analyst Certification and important disclosures.

[1]Citigroup Global Markets India Private Limited; [2]Citigroup Global Markets Asia

Figure 1. Deal Structure

Rs m		Comments
Cash outgo	37,869	Modi's stake and 20% open offer at Rs77/share (assuming no TM contribution) + Rs5,440m non-compete fee
Cash inflow	72,944	Preferential allotment of 464m shares to TMI at Rs157/share
Net cash inflow	**35,075**	
TMI's combined stake - base case		
Additional Idea shares on merger (m)	132.5	TMI's 39.2% stake in Spice swapped at 0.49:1 ratio. Assuming TMI does not acquire more shares in the open offer
Eventual TMI stake (%)	18.5%	
TMI's combined stake - assuming TM participates in the open offer		
Additional Idea shares on merger (m)	166.3	TMI's stake in Spice swapped + TMI participates to the tune of 50% in the open offer
Eventual TMI stake (%)	19.3%	
Non-compete fee		
Modi's stake sale (Rs m)	21,761	Value for Modis stake in Spice at Rs77/share
Non-compete fee as % of transaction value	25.0%	Maximum permissible limit under SEBI rules

Source: Citi Investment Research

Figure 2. Deal Valuation Summary

Rs m	FY09E	FY10E
EBITDA		
Idea	29,855	36,450
Spice	4,086	5,086
Combined EBITDA	**33,941**	**41,536**
O/S shares - fully diluted	3,236	3,236
Debt (on year-end)		
Idea	75,000	90,000
Spice	15,725	14,975
Total debt	**90,725**	**104,975**
Cash		
Idea	7,170	7,114
Spice	2,256	3,110
Providence transaction	26,240	26,240
Cash inflow from TMI	72,944	72,944
Cash outflow for open offer + non compete fees	37,869	37,869
Total cash (on year-end)	**70,741**	**71,539**
Net debt (on year-end)	19,984	33,436
Market cap (@Rs102/share)	330,109	330,109
EV of combined entity	350,093	363,545
EV/EBITDA	**10.3**	**8.8**
Standalone Idea's valuations		
EV/EBITDA (@Rs102/share)	10.4	8.9
Merger premium/disc to standalone	-0.8%	-2.0%

Source: Citi Investment Research

Figure 3. Valuation Comparisons

		M Cap	Price	P/E (x)		EV/EBITDA (x)	
Company name	**Rating**	**US$M**	**6/25/2008**	**FY09E**	**FY10E**	**FY09E**	**FY10E**
Bharti	1L	34,622	780	17.5	14.5	10.2	8.2
RCOM	1L	24,572	509	14.4	12.0	9.7	7.7
Idea	1L	6,289	102	22.1	18.8	10.4	8.9

Source: Citi Investment Research

IDEA Cellular

Company description

Idea Cellular, a pure-play wireless provider, is the fifth-largest cellular operator in India. It has licenses to provide cellular-phone services in 13 of the 23 telecom circles in India and an active presence in 11 of them. The company listed on the Indian bourse in March 2007 and is part of the Aditya Birla Group.

Investment strategy

We rate Idea Buy/Low Risk. Continued robust wireless market expansion and Idea's ability to regain its growth potential following its restructuring and full control by Aditya Birla Group are key factors in our investment argument. Idea's strong competitive position in its existing circles and comparable operational parameters provide us sufficient comfort in management's ability to execute its plans. With a relatively smaller base compared to larger peers, we estimate earnings CAGR of 41% over FY07-10E, ahead of peers and more than double that of the broader market. However, post the disappointing quality of earnings in 2Q, the Idea stock will likely decouple from Bharti, with a renewed upsurge in investor sentiment probably hinging on a turnaround in operational data points.

Valuation

We have set our 12-month target price at Rs140 based on Sep-08E DCF of Rs108 and towerco option value of Rs32/share through its 16% stake in Indus. We prefer DCF as our primary valuation methodology due to the back-ended nature of free cash flows given the new circle roll-outs. Our DCF assumes a WACC of 10.8% at a target debt to capital of 50.0% and terminal growth rate of 4.0% (similar to Bharti). Our DCF is based on explicit forecasts for FY07-16E with a terminal year EBITDA margin at 39.3% (~600bps below Bharti) and capex/sales of ~8% (in line with Bharti). The DCF value implies an EV/EBITDA of 11.8x, slightly lower than Bharti's target multiples (for the ex-towerco portion of Rs930), which is supported by Idea's higher growth rates notwithstanding Idea's smaller size and relatively less established track record.

Risks

Our quantitative risk-rating system assigns a default Speculative Risk rating to Idea due its trading history of less than 12 months. We see a Low Risk rating as more appropriate due to the higher visibility of Indian wireless growth, Idea's reasonably competitive position and strong parentage. Operationally, the risks facing Idea are slightly higher than its more established peers given the roll-out in new circles. Project cost over-runs, delays in spectrum allocation and hence commercial launches could affect the value accretion opportunity in new circles. Idea will also face competition from established players in new circles and market share gains may be lower than expected. Idea will incur higher capex requirements in the new circles due to the coverage compulsions, which may depress return parameters in the initial years. Any rollout plans beyond 13 circles may also require a fresh equity infusion. These risk factors could impede the stock from reaching our target price.

Valuations and Risks – Other Stocks

Bharti Airtel (BRTI.BO; Rs780.00; 1L)

Valuation

Our 12-month forward target price of Rs1,150 is based on Sep-08 core DCF of Rs930 and a towerco option value of Rs220. The DCF is based on a WACC of 10.7%, a terminal growth rate of 4% and beta of 0.9. We prefer DCF as our primary valuation methodology because the wireless market will likely continue to see robust growth requiring upfront capex but should generate significant free cash beyond FY09-10E. Our target price (net of towerco value) represents a FY09E P/E of 20.9x, P/CEPS of 13.2x and EV/EBITDA of 12.1x.

Risks

Our quantitative risk-rating system, which tracks 260-day share price volatility, rates Bharti as Low Risk. We are comfortable attributing a Low Risk rating for the following reasons: 1) Bharti has a track record of profitability and execution; 2) the company's capex plans are fully funded; and 3) SingTel's strategic shareholding leaves us comfortable with execution issues and initiatives. Risks that could prevent the stock from reaching our target price include competition-led tariff pressures, un-remunerative capex, overall market downside, and slower-than-expected execution of the tower-sharing initiative.

Reliance Communications (RLCM.BO; Rs509.05; 1L)

Valuation

Our 12-month forward target price of Rs760 is based on a core business fair value of Rs620 and net towerco value of Rs140. We usually value Indian wireless plays on DCF given the back-ended nature of profits and cash flow. For RCOM, however, we use EV/EBITDA. Our 12-month core business value of Rs620 is based on 9.2x FY10E EV/EBITDA (by when RCOM's GSM roll-out would be fully evolved), at 5% discount to Bharti's implied target multiple (ex-towerco).Notwithstanding the narrowing of the leadership gap vs. Bharti, we believe that the dual network strategy carries inherent risks of cost duplication and/or execution which prompts us to retain the valuation discount. Higher-than-average earnings growth (CAGR of 41% over FY07-10E) and the low sensitivity of wireless demand to interest rates should continue to support premium valuations for the sector, in our view.

Risks

Our risk-rating system, which tracks 260-day share price volatility, assigns a High Risk rating to RCOM, but we believe Low Risk is more appropriate. RCOM has been de-merged from Reliance Industries, and its shareholding at the time of listing mirrored the holding of RIL. The stock is therefore unlikely to have risks that are typical of newly listed companies. Besides, growth in the telecoms sector gives visibility to RCOM's prospects. Downside risks to our target price include smaller-than-expected market share, lower-than-anticipated operating leverage due to handset subsidies, cost-overruns in GSM overlay, regulatory and competition risks and un-remunerative capex.

Appendix A-1

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IMPORTANT DISCLOSURES

Bharti Airtel (BRTI.BO)

Ratings and Target Price History - Fundamental Research

Analyst: Rahul Singh (covered since April 28 2006)

#	Date	Rating	Target Price	Closing Price
1:	22 Aug 05	1M	*400.00	306.10
2:	10 Jan 06	1M	*450.00	339.25
3:	13 Apr 06	1M	*500.00	395.95
4:	12 Oct 06	*1L	*600.00	475.65
5:	2 Jan 07	1L	*750.00	633.00
6:	23 Jan 07	1L	*800.00	689.15
7:	21 Feb 07	1L	*960.00	806.30
8:	20 Jun 07	1L	*1,050.00	824.65
9:	8 Oct 07	1L	*1,200.00	984.80
10:	12 Feb 08	1L	*1,150.00	855.80

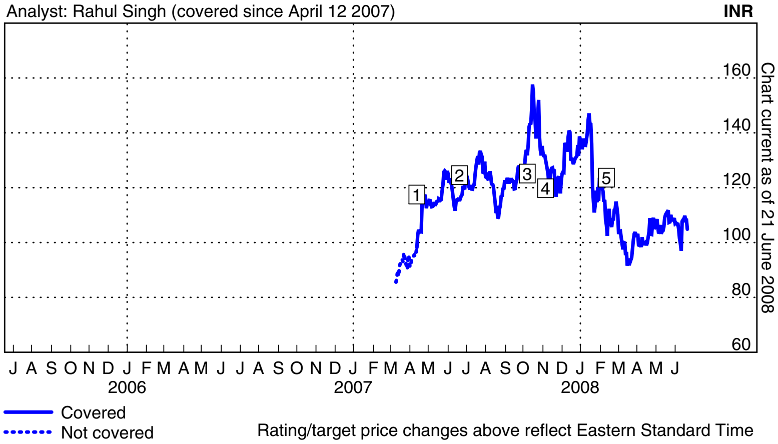
*Indicates change.

Rating/target price changes above reflect Eastern Standard Time

IDEA Cellular (IDEA.BO)

Ratings and Target Price History - Fundamental Research

Analyst: Rahul Singh (covered since April 12 2007)



#	Date	Rating	Target Price	Closing Price
1:	12 Apr 07	1L	112.00	98.15
2:	20 Jun 07	1L	*140.00	115.15
3:	8 Oct 07	1L	*155.00	131.80
4:	6 Nov 07	*2L	*140.00	130.10
5:	12 Feb 08	*1L	140.00	106.25

*Indicates change.

Rating/target price changes above reflect Eastern Standard Time

Reliance Communications (RLCM.BO)

Ratings and Target Price History - Fundamental Research

Analyst: Rahul Singh (covered since May 30 2006)

#	Date	Rating	Target Price	Closing Price
1:	29 May 06	1M	360.00	276.25
2:	12 Oct 06	1M	*430.00	345.95
3:	2 Jan 07	1M	*570.00	470.75
4:	9 Apr 07	1M	*510.00	415.60
5:	20 Jun 07	1M	*600.00	505.90
6:	8 Oct 07	*1L	*750.00	640.90
7:	6 Nov 07	*2L	*835.00	745.40
8:	12 Feb 08	*1L	*760.00	575.70

*Indicates change.

Rahul Singh holds a long position in the shares of Bharti Airtel.

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