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Telecom

SECTOR UPDATE

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New Telecom Policy 2011 — Here Comes The Revolution

In light of the fundamental changes that are likely to be introduced by the impending New Telecom Policy (NTP) 2011, we reiterate our BUY on Bharti (BHARTI IN, mcap US$30bn, TP: Rs425, 19% upside), SELL on Idea (IDEA IN, mcap US$4.8bn, TP Rs60, 10% downside) and HOLD on RCom (RCOM IN, mcap US$5.5, TP Rs120, 9% upside).

Over the next few months, the Telecom Ministry is expected to publish the NTP 2011, which is expected to give a new direction to the sector while simultaneously removing the anomalies present in the current system. Whilst most of the telcos agree on the key issues such as bringing IP (I) services under the licencing regime, changes in rollout obligations and merger and acquisition norms, issues on which the major telcos differ are spectrum allocation and its pricing, renewal fees, licence fees and re-farming of spectrum at the time of renewal of licences.

Our expectation of major policy changes

Relaxation in M&A norms

Current M&A guidelines which restricts subscriber and revenue market share at 40% in each circle and maximum spectrum to be 15MHz does not facilitate consolidation in the industry. The current guidelines allow entry to unlimited number of players but the exit is restricted.

The highlight of the NTP 2011 would be relaxation of M&A norms. This will (apart from providing an exit route to loss making/ unsuccessful operators) reduce competition and release spectrum for other operators. The released spectrum can then be distributed among the remaining players, which should reduce scarcity of spectrum and also help operators utilize spectrum in more efficient manner.

Due to stringent policy norms at present, in each circle India has 11-12 operators providing services. This is among the highest anywhere in the world. Out of 12 operators, only two operators, namely Bharti and Vodafone are generating positive free cash flows. And given the competitive scenario and lower tariffs operators like Aircel, Uninor, Shyam Sistema will take a long time to generate any kind of decent return on investment. Post relaxation in M&A norms we expect players with strong balance sheets such Vodafone to lead the consolidation. Also, once the Government decides to charge for excess spectrum beyond 6.2MHz and re-price new licences it will put pressure on the balance sheets of not only new entrants but also existing operators such as Aircel and Idea.

Charge for excess spectrum

TRAI has recommended pricing for excess spectrum beyond 6.2MHz at 136% of the 3G spectrum price at a pan-India level. Based on this, BSNL/MTNL would be the worst impacted, with the potential liability being Rs75bn (BSNL/MTNL holds more than 6.2MHz spectrum in all circles except Punjab). In the listed space, the liability would be as follows: Bharti - Rs33bn (Rs8.7/share, 6.7% of FY11E net worth), Idea Cellular - Rs13.3bn (Rs4/share, 11% of FY11E net worth) and RCom - Rs788mn (Rs0.38/share, 0.2% of FY11E net worth). The Government is expected to get Rs145bn from this re-pricing exercise.

Apart from this, TRAI has also identified the value of contracted 2G spectrum (up to 6.2MHz) at Rs17.7bn/MHz for the pan-India level. This implies that 2G spectrum in being valued at 53% of 3G spectrum price. For new licencees, spectrum beyond 4.4MHz would be charged at this rate.

Delinking of licence and spectrum and limiting spectrum to 4.4MHz for new operators

As mentioned before, the Government has also proposed to charge a market determined rate for spectrum beyond 4.4MHz for new operators. This will weaken the business case of most of the new operators as the cost of spectrum would be much higher. Operators who will be impacted due to this include RCom, Tata Tele, Uninor, Etisalat etc

Based on TRAI recommendations, the amount that RCom might need to pay for incremental 1.8MHz specrum stands at R27bn (Rs13.2/ share, 7.2% of FY11E net worth). At a pan-India level, each operator would have to pay Rs31.8bn for the incremental 1.8MHz spectrum.

Reduction in licence fees to a uniform 6%

In the case of unified access service (UAS) licences, the licence fee (LF) is 10/8/6% of adjusted gross revenue (AGR) for Metro, Circle A/B/C areas respectively. For national long distance (NLD) and international long distance (ILD) services the LF stands at 6% of AGR. This creates incentives for telcos to misreport revenues to save the LF paid to the Government. Industry participants have been demanding a uniform LF at 6%. TRAI has also recommended that the LF to come down to 6% over a period of next four years. We expect the Government to make LF at a 6% uniform in NTP 2011. Bharti accounts for 32% of the total LF received by the Government. During FY10, the company paid LF of Rs23.8bn. Hence for Bharti, reduction in LF as a percentage of AGR to 6% would result in savings of Rs8.7bn in FY12E (Rs2.3/share, 10% of FY12E EPS). In the case of Idea, the savings would be Rs3.9bn (Rs1.2/ share, 85% of FY12E EPS) and for RCom, the savings are estimated to be Rs2.3bn (Rs 1.1/ share, 15.5% of FY12E EPS).

The Government has also mooted a move to levy licence fees and spectrum charges as a percentage of adjusted gross revenue (AGR) subject to a minimum presumptive AGR in light of the lost revenues from the failure to roll out operations by some of the new operators. For example, Bharti pays 32% of the fees to the Government for the 12% spectrum it owns whilst the new operators pay 1% of the overall revenue to the Government despite owning 28% of the country's spectrum. If the Government decides to implement this, it will have a negative impact on most of the new entrants as the losses may go up further. This could lead to the potential exit of unsuccessful operators.

Threat of renewal charges for incumbent telcos overdone

Based on TRAI's recommendations dated 9 Feb 2011, the impact of licence renewal is estimated to be as follows: Bharti - Rs80bn (Rs21/share, 19% of FY11E net worth), Idea - Rs72.8bn (Rs22/share, 64% of FY11E net worth) and RCom Rs18bn (Rs8.7/ share, 4.6% of FY11E net worth). However, we believe that market is over-reacting in terms of the potential liability on account of renewal of licences as the TRAI's recommendations on this front are unlikely to come through. First, other than Bharti and Vodafone, the rest of the players in the system will not be able to pay this liability. Second, between now and the renewal date (FY15) we expect consolidation to take place in the Indian telecom sector. This will release lots of spectrum for operators and hence the scarcity of spectrum will be taken care of thereby reducing the excess demand for spectrum. Third, we expect incremental spectrum to get released from the Government in bands such as 2,500MHz, 2,300MHz and 700MHz. This will reduce operators' dependence on 2G spectrum to a certain extent.

Fourth, the Telecom Minister's comments in the roundtable conference dated March 8, 2011 (that, if the Government charges for the renewal of licences, there will be two sets of players operating in the system: Those who have paid higher charges for renewal and the new entrants who have just entered the system two-three years back at 2001 prices) suggest that the Government is reluctant to create a two-tier sector.

Taking into consideration these factors we believe that the renewal charges will be significantly below the TRAI recommendations published on 9 Feb 2011.

Re-pricing of new licences given in 2008 as well as licences given post 2001

The entire premise of charging 2001 rates while giving licences in 2008 was to maintain a level playing field among incumbent operators and new entrants. Therefore, once the Government decides to charge renewal fees, it will also need to re-price licences given not only in 2008 but all the licences allotted post 2001. As indicated earlier, the same problem has also been raised by the Telecom Minister during the roundtable conference.

Another reason we believe why the Government can go ahead and reprice these licences is the ambiguous nature of first-come-first-serve policy (FCFS), as indicated in the One Man Committee Report dated January 31, 2011. As per NTP 1999, it was decided that the entry of new players will be based on TRAI's recommendations. TRAI in its recommendations dated October 27, 2003, which were accepted by the Cabinet, had stated that allocation of incremental UAS licence should be through multi-stage bidding as followed in the case of 4th cellular operator. Despite this, the DoT adopted the FCFS process, which was neither being vetted by the Cabinet, nor the Telecom Commission nor the Finance Ministry. Therefore the FCFS policy lacks legitimacy and is likely to be ditched in the NTP with the NTP 2011 then recommending a re-pricing of the new licences.

Based on TRAI's recent recommendations, the re-pricing of UAS licences given between 2005-2008 will have the following impact: (1) Bharti Airtel (nil), Idea Cellular (Rs16bn, Rs4.9/sh, 13.3% of FY11 net worth) and RCom (Rs27.2bn, Rs13.2/sh, 7.2% of FY11 net worth). Among unlisted players, Aircel would face the maximum impact of Rs48.7bn as it received 14 licences in December 2006.

Overall investment implications

Bharti Airtel: Bharti in our view is the best placed telco not just in terms of monetization of 3G services but also in terms of financial exposure to re-pricing of licences and charges for excess spectrum. The stock is currently trading at 7.2x FY12E EV/EBITDA. We reiterate our BUY stance with a target price of Rs425 (implied FY12E EV/EBITDA at 8.2x). This indicates an upside of 19% from current levels.

Idea Cellular: The launch of 3G services would result in higher network operating costs for the company. Apart from this, spectrum amortisation (Rs2,884mn/annum) and interest expense related to the 3G spectrum acquisition are expected to impact profitability significantly. On the regulatory front, the potential liability on account of excess spectrum and re-pricing of new licences will further increase the risks faced by the company. The stock is currently trading at 8x FY12E EV/EBITDA. Our DCF-based March 2012 target price stands at Rs60 (implied FY12E EV/EBITDA at 7.5x). We reiterate our SELL stance on the stock.

RCom: RCom's current market price factors in poor operational and financial performance. Going forward, we believe that if the company manages to relieve pressure on its balance sheet, it could provide upside to the stock. The stock is currently trading at 7.4x FY12E EV/EBITDA. Our DCF-based March 2012 target price stands at Rs120 (implied FY12E EV/EBITDA at 7.7x). We reiterate our HOLD stance on the stock.

Other stocks which may get impacted due to 2G regulations (from our Real Estate analyst, Parikshit Kandpal, parikshitkandpal@ambitcapital.com, Tel: +91 22 3043 3201)

Unitech: (UT IN, mkt cap $2.3bn, UNDER REVIEW) may be impacted negatively by the spectrum re-pricing via its 32.75% holding in Uninor. The liability for Uninor from the pan-India Telecom licence re-pricing could be Rs62bn and for Unitech's stake, this may amount to a Rs20bn incremental credit guarantee. The current D/E of 0.4x for Unitech may therefore go up to 0.6x on account of this contingent liability. Whilst credit lines appearto be tied up, Uninor is looking at funding its telecom expansion through a rights issue citing the reason of debt being costlier than equity. With Unitech pushing for Uninor to raise debt (as opposed to equity), an equity raise will obviously impact the valuation of its stake in Uninor (currently worth Rs7-8/share at book value). Further, the events surrounding 2G scam has already resulted in a 56% stock correction in Unitech's share price since November 8, 2010 (the date of the CAG report), with the company now trading below its land cost of ~Rs51/share (current stock price Rs40).

Explanation of Investment Rating

Investment Rating	Expected return (over 12-month period from date of initial rating)
Buy	>15%
Hold	5% to 15%
Sell	<5%

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