

Company Flash

15 November 2006 | 6 pages

MTNL (MTNL.BO)

Sell: Tax Refund On Its Way?

- IT Department's appeal has been denied** — The Income Tax Department's appeal to the Committee of Disputes (CoD) to drag the tax refund case to the High Court has been denied. This raises hope of ultimate recovery of Rs17-18bn of refunds (Rs14b principal and Rs3-4bn interest) i.e.Rs28/share. Eventual refund is likely higher than Rs15bn (provisional) due to interest.
- This issue is not new, however** — MTNL had won the IT Tribunal award for allowing license fee as tax deductible item, two years back. However, it has yet to receive any refund in cash – the only compensation of Rs2.5b was through a setoff against an outstanding tax demand. The refunds pertain to nine assessment years (FY1996-2004) for which MTNL has already paid advance tax.
- Some hurdles still remain** — MTNL has paid advance tax in excess of tax provision of ~Rs26bn (Rs40/share), which includes license fee case as well as the pending 80IA issue. However, IT has also raised a penalty of Rs8.5bn in the 80IA case, which could be used to set off the refunds in the license fee case. The timing of hard cash inflows therefore remains uncertain.
- Cash refunds only a temporary respite** — With pressure on core business evident in 1HFY07, cash + potential refunds (Rs60/share) only act as support at best. MTNL's adjusted EV/EBITDA at 5.0x FY08E is well priced given the business outlook. Favorable ruling in the pending IT case poses upside risk. Meanwhile, monetisation of real estate is fraught with execution risks.

Sell/Low Risk	3L
Price (15 Nov 06)	Rs143.50
Target price	Rs97.00
Expected share price return	-32.4%
Expected dividend yield	3.1%
Expected total return	-29.3%
Market Cap	Rs90,405M US\$2,006M

Statistical Abstract

Year to	Net Profit	Diluted EPS	EPS growth	P/E	P/B	ROE	Yield
31 Mar	(RsM)	(Rs)	(%)	(x)	(x)	(%)	(%)
2004A	11,501	18.26	31.0	7.9	0.9	11.6	3.1
2005A	9,390	14.90	-18.4	9.6	0.8	8.8	3.1
2006E	6,775	10.75	-27.8	13.3	0.8	6.1	3.1
2007E	5,023	7.97	-25.9	18.0	0.8	4.4	3.1
2008E	4,042	6.42	-19.5	22.4	0.8	3.5	2.8

Source: Powered by dataCentral

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See page 4 for Analyst Certification and important disclosures.

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Figure 1. Financial performance has been uninspiring

Rs m	2Q06	1Q07	2Q07	Q/Q Growth %	Y/Y Growth %
Income from services	12,690	12,724	12,204	(4.1)	(3.8)
Staff cost	(4,641)	(4,489)	(4,596)	2.4	(1.0)
Interconnect costs	(2,154)	(2,132)	(2,256)	5.8	4.7
License Fee	(1,218)	(1,144)	(1,097)	(4.1)	(9.9)
Administrative / operative expenditure	(2,245)	(2,233)	(2,327)	4.2	3.7
EBITDA	2,432	2,726	1,928	(29.3)	(20.7)
PBT	2,311	1,793	1,839	2.6	(20.4)
PAT	1,679	1,182	1,210	2.4	(27.9)

Source: Company Reports

Figure 2. Pressure on Core Business not offset by new revenue streams

Rs m	1QFY06	2QFY06	3QFY06	4QFY06	1QFY07	2QFY07	Q/Q Growth %	Y/Y Growth %	Comments
Basic Telephone	10,455	10,336	10,968	12,028	9,950	9,284	(6.7)	(10.2)	
<i>Rentals</i>	2,658	2,670	3,382	2,827	2,903	2,714	(6.5)	1.7	Loss of Fixed line connections (90k) affect rental income
<i>Call Charges & Other Revenue</i>	7,090	6,549	6,730	7,827	6,100	5,962	(2.3)	(9.0)	Tariff cut in long distance affects the usage revenue
<i>Interconnection</i>	707	1,118	855	1,374	947	608	(35.8)	(45.6)	
Cellular	1,152	1,364	1,529	1,566	1,795	1,872	4.3	37.3	QoQ growth in cellular revenues has slowed down due to lower adds
WLL	273	214	109	149	236	175	(25.8)	(18.1)	
Other Services	724	854	64	710	743	873	17.5	2.2	
Income from Services	12,605	12,768	12,670	14,453	12,724	12,204	(4.1)	(4.4)	
Other Income	1,348	1,673	848	1,492	789	1,564	98.2	(6.5)	Other Income has increased on account of Interest on IT refunds
Total Income	13,953	14,441	13,517	15,945	13,513	13,768	1.9	(4.7)	

Source: Company Reports

MTNL

Company description

Mahanagar Telephone Nigam Limited (MTNL) operates a telecommunications company, which provides basic phone, Internet and cellular mobile telephony services in Delhi and Mumbai. The Company establishes, maintains, and manages telecommunication facilities in these cities.

Investment thesis

We rate MTNL Sell/Low Risk (3L), with a target price of Rs97 based on the average of our DCF estimate and a P/E of 9x FY06E EPS. Our earnings estimates for FY06-08 are now 20-60% below consensus. MTNL's core business decline continues and mobile/broadband is unlikely to compensate for the decline. Private operators continue to cherry-pick the lucrative customers in Mumbai and Delhi. Additionally, the PCO business contributes around 21% of revenue. These revenues still have downside potential. Cost pressure, especially on the employee cost front, will likely continue. The company may be required to absorb 2,000 employees of the DoT, increasing its already bloated 54,000-employee base (vs. Bharti's 9,000 employees). The pension liability could

increase according to new accounting norms in Indian GAAP. Cash on the books is unlikely to be paid out in the form of one-time dividends. Capex is high, and the risk is high that cash will be reduced by paying down liabilities and potential acquisitions. The Indian GAAP accounting has potential for downside as it is not conservative — US GAAP numbers are around 60% lower.

Valuation

We value MTNL using DCF and P/E. We assume a risk-free rate of 7%, risk premium of 7%, beta of 0.93, and terminal growth of 3%. On P/E, we value MTNL at 9x FY06 P/E. MTNL has traded in a band of 6-10x between April 2001 and October 2004, with an average P/E of 8.7x. Our target multiple of 9x is 10% below the median P/E of our regional telecom universe and 30% below the target BSE-Sensex multiple. However, given the continuous decline in profits, we believe that 8x represents a reasonable valuation metric.

Risk

We rate MTNL Low Risk based on our quantitative risk-rating system. The upside risks that could prevent the stock from achieving our target price include: (1) Merger with BSNL; (2) License fee refund would lead to cash inflow; (3) Refund of 80I(A); and (4) Broadband business related upside.

Analyst Certification Appendix A-1

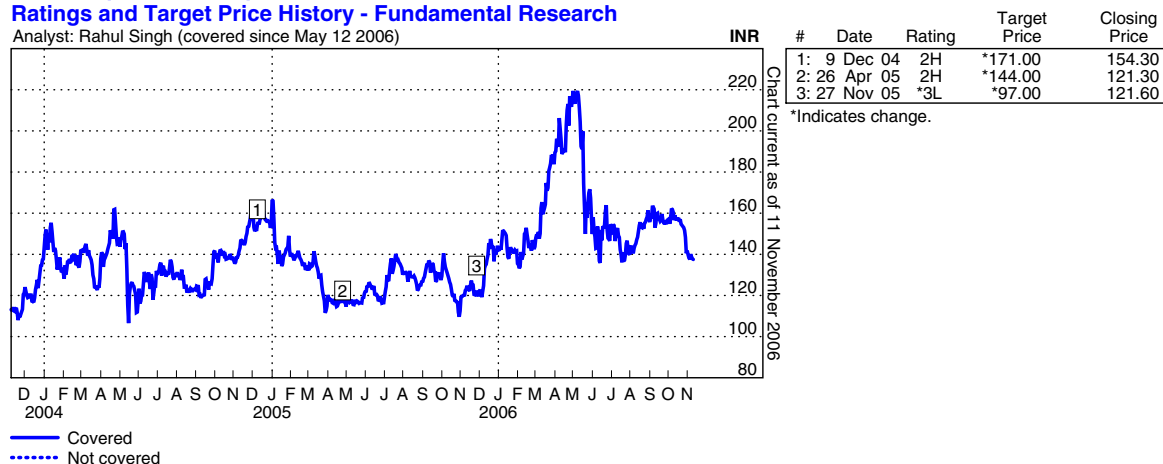
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Analyst: Rahul Singh (covered since May 12 2006)



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