

Company Focus

30 January 2008 | 8 pages

Bharti Airtel (BRTI.BO)

3QFY08 – Show of Strength

- Wireless powers an in-line quarter** — Bharti's 3QFY08 EBITDA at Rs29.6bn was broadly in line as strong wireless EBITDA and operating leverage in Fixed line/Broadband negated pressure in Enterprise segments. PAT was exactly in line as lower finance and tax charges compensated for higher depreciation.
- Price elasticity still alive** — Wireless KPIs surprised slightly on the positive with moderate ARPU decline (2.2%qoq), as MOUs responded well to selective price cuts and seasonality; rev/min decline was slower due to higher % of outgoing calls. Signs of elasticity bode well for 4QFY08 given the pre-paid tariff cuts in early-Jan. Though EBITDA % declined 20bps due to higher quarterly run-rate of site additions at 7.5-8.0k (4.5-5.0k in FY07), mobile EBITDA was in line.
- Focus on EBIT margins from 4Q** — Management indicated that Bharti will start paying rentals to the towercos from Feb-08 which will lower EBITDA margins but also lower depreciation charge. We estimate FY09E EBITDA margin impact to be 160bps (assuming tenancy of 1.5x) which could be more than offset by depreciation savings (~6-7% of fixed assets; Rs70bn transferred to towercos).
- Other business showing promise, DTH launch in 1QFY09** — ILD volume growth accelerated during 3Q with the acquisition of 2i though margins came in under pressure with rising competitive intensity. Fixed line/broadband had a stellar quarter with Bharti's strategy of cherry picking customers and latent operating leverage resulted in huge margin expansion for second quarter in a row. Meanwhile DTH launch is likely in 1QFY09. Bharti remains our top pick

| | |
|------------------------------|--------------|
| Buy/Low Risk | 1L |
| Price (30 Jan 08) | Rs862.25 |
| Target price | Rs1,200.00 |
| Expected share price return | 39.2% |
| Expected dividend yield | 0.0% |
| Expected total return | 39.2% |
| Market Cap | Rs1,636,450M |
| | US\$41,640M |

Price Performance (RIC: BRTI.BO, BB: BHARTI IN)



Figure 1. Statistical Abstract

| Rs m | 3QFY07 | 2QFY08 | 3QFY08 | Y/Y (%) | Q/Q (%) |
|----------------------|--------|--------|--------|---------|---------|
| Income from Services | 49,129 | 63,374 | 69,639 | 41.7 | 9.9 |
| Access Charges | 8,242 | 9,317 | 10,424 | 26.5 | 11.9 |
| Network Op. Costs | 5,328 | 7,520 | 8,851 | 66.1 | 17.7 |
| Staff + SGA | 10,930 | 13,159 | 13,739 | 25.7 | 4.4 |
| License Fee | 4,574 | 6,281 | 6,991 | 52.8 | 11.3 |
| EBITDA | 20,055 | 27,097 | 29,634 | 47.8 | 9.4 |
| PBT | 14,412 | 17,471 | 19,032 | 32.1 | 8.9 |
| PAT | 12,151 | 16,139 | 17,224 | 41.7 | 6.7 |

Source: Citi Investment Research

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| Fiscal year end 31-Mar | 2006 | 2007 | 2008E | 2009E | 2010E |
|--|----------------|----------------|-----------------|-----------------|-----------------|
| Valuation Ratios | | | | | |
| P/E adjusted (x) | 72.4 | 38.4 | 23.8 | 18.4 | 15.4 |
| EV/EBITDA adjusted (x) | 38.8 | 22.6 | 14.5 | 10.8 | 8.8 |
| P/BV (x) | 17.7 | 12.1 | 8.5 | 6.2 | 4.7 |
| Dividend yield (%) | 0.0 | 0.0 | 0.6 | 1.1 | 1.3 |
| Per Share Data (Rs) | | | | | |
| EPS adjusted | 11.92 | 22.45 | 36.23 | 46.94 | 56.13 |
| EPS reported | 11.92 | 22.45 | 36.23 | 46.94 | 56.13 |
| BVPS | 48.67 | 71.50 | 101.69 | 138.12 | 181.72 |
| DPS | 0.00 | 0.00 | 5.40 | 9.40 | 11.20 |
| Profit & Loss (RsM) | | | | | |
| Net sales | 116,215 | 185,196 | 272,447 | 354,292 | 420,577 |
| Operating expenses | -88,610 | -135,896 | -190,060 | -242,567 | -286,917 |
| EBIT | 27,605 | 49,300 | 82,387 | 111,725 | 133,660 |
| Net interest expense | -2,512 | -1,438 | -3,584 | -5,496 | -4,390 |
| Non-operating/exceptionals | 272 | 999 | 2,000 | 1,000 | 500 |
| Pre-tax profit | 25,365 | 48,861 | 80,803 | 107,229 | 129,770 |
| Tax | -2,539 | -5,822 | -12,120 | -18,229 | -23,359 |
| Extraord./Min.Int./Pref.div. | -260 | -468 | 0 | 0 | 0 |
| Reported net income | 22,566 | 42,571 | 68,682 | 89,000 | 106,412 |
| Adjusted earnings | 22,566 | 42,571 | 68,682 | 89,000 | 106,412 |
| Adjusted EBITDA | 42,981 | 74,125 | 116,743 | 157,592 | 189,384 |
| Growth Rates (%) | | | | | |
| Sales | 45.2 | 59.4 | 47.1 | 30.0 | 18.7 |
| EBIT adjusted | 47.4 | 78.6 | 67.1 | 35.6 | 19.6 |
| EBITDA adjusted | 44.8 | 72.5 | 57.5 | 35.0 | 20.2 |
| EPS adjusted | 47.4 | 88.4 | 61.3 | 29.6 | 19.6 |
| Cash Flow (RsM) | | | | | |
| Operating cash flow | 48,320 | 70,548 | 127,425 | 159,108 | 180,902 |
| Depreciation/amortization | 15,376 | 24,825 | 34,356 | 45,867 | 55,724 |
| Net working capital | 7,295 | -672 | 21,124 | 18,745 | 14,376 |
| Investing cash flow | -54,095 | -72,788 | -135,799 | -123,920 | -113,700 |
| Capital expenditure | -57,309 | -74,798 | -136,025 | -124,301 | -114,867 |
| Acquisitions/disposals | 3,631 | 1,952 | 0 | 0 | 0 |
| Financing cash flow | 5,338 | 7,054 | 4,744 | -23,801 | -39,297 |
| Borrowings | -806 | 7,428 | 20,000 | 2,000 | -10,000 |
| Dividends paid | 0 | 0 | -11,446 | -19,924 | -23,740 |
| Change in cash | -438 | 4,813 | -3,630 | 11,388 | 27,905 |
| Balance Sheet (RsM) | | | | | |
| Total assets | 215,681 | 296,690 | 400,033 | 493,657 | 582,110 |
| Cash & cash equivalent | 2,649 | 7,464 | 3,833 | 15,221 | 43,126 |
| Accounts receivable | 14,203 | 17,982 | 21,796 | 24,800 | 25,235 |
| Net fixed assets | 180,971 | 248,403 | 350,394 | 428,827 | 487,970 |
| Total liabilities | 122,545 | 159,336 | 205,442 | 229,991 | 235,772 |
| Accounts payable | 0 | 0 | 0 | 0 | 0 |
| Total Debt | 34,503 | 52,461 | 72,461 | 74,461 | 64,461 |
| Shareholders' funds | 93,135 | 137,354 | 194,590 | 263,666 | 346,338 |
| Profitability/Solvency Ratios (%) | | | | | |
| EBITDA margin adjusted | 37.0 | 40.0 | 42.8 | 44.5 | 45.0 |
| ROE adjusted | 29.5 | 37.4 | 41.8 | 39.2 | 35.1 |
| ROIC adjusted | 21.7 | 27.0 | 30.4 | 31.0 | 31.2 |
| Net debt to equity | 34.2 | 32.8 | 35.3 | 22.5 | 6.2 |
| Total debt to capital | 27.0 | 27.6 | 27.1 | 22.0 | 15.7 |

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Concerns on elasticity partially addressed; 4Q will be key

While Bharti recently cut tariffs for lifetime subs in Dec 07 and followed it by slashing outgoing call rates on pre-paid (ex-lifetime) to Rs1/min from an estimated national average of Rs1.4-1.5/min, management mentioned that price elasticity still exists in some segments – pre-paid and even lifetime. This was evident from pick-up in MOUs during the quarter notwithstanding the seasonality benefit. This bodes well for 4QFY08 and FY09 MOUs esp. in the context of recent pre-paid tariff cuts. In addition, in:out mix improved during the quarter resulting in slower decline in revenue per min (3.3%qoq vs. 4.5%qoq decline in 2Q).

Figure 2. Wireless business parameters

| Rs m | 1Q07 | 2Q07 | 3Q07 | 4Q07 | 1Q08 | 2Q08 | 3Q08 | Remarks |
|---------------------------|---------|---------|---------|---------|---------|---------|---------|--|
| Revenue | 28,411 | 33,022 | 37,579 | 42,431 | 46,976 | 50,579 | 56,105 | 11% QoQ revenue growth supported by moderate decline in ARPU |
| EBITDA | 10,341 | 12,179 | 14,129 | 16,604 | 19,087 | 20,728 | 22,887 | |
| EBITDA margin (%) | 36.4 | 36.9 | 37.6 | 39.1 | 40.6 | 41.0 | 40.8 | Margins under pressure with rising network opex |
| ARPU | 441 | 438 | 427 | 406 | 390 | 366 | 358 | Moderate decline in ARPU, positive surprise |
| MoU | 441 | 451 | 467 | 475 | 478 | 469 | 474 | Price elasticity resulting from lifetime tariff cuts + seasonality. Pre-paid MOUs up 14.7% |
| Prepaid as % of net adds | 93.7 | 92 | 96.2 | 97.3 | 97.5 | 95.4 | 95.4 | 35% of incremental subs from lifetime |
| Data as % of revenues | 10.8 | 10.3 | 10.4 | 10.1 | 9.9 | 9.8 | 9.3 | |
| Number of sites | | | 34,307 | 39,224 | 45,784 | 52,826 | 60,299 | |
| Census towns | 4,026 | 4,357 | 4,581 | 4,676 | 4,855 | 4,876 | 4,902 | |
| Non-census towns/villages | 101,614 | 155,076 | 176,593 | 207,327 | 243,584 | 290,000 | 320,623 | |
| Population coverage | 46% | 50% | 54% | 59% | 62% | 65% | 68% | On track to achieve 80-85% coverage by FY09 |
| Minutes (mn) | 28194 | 33844 | 41305 | 49240 | 57125 | 64375 | 73840 | Robust 15%qoq growth in minutes continues |
| Revenue per minute (Rs) | 1.01 | 0.98 | 0.91 | 0.86 | 0.82 | 0.79 | 0.76 | QoQ decline in rev/min slowed despite higher proportion of lifetime subs |
| EBITDA per minute (Rs) | 0.37 | 0.36 | 0.34 | 0.34 | 0.33 | 0.32 | 0.31 | |
| Capex per minute (Rs) | 2.74 | 3.51 | 1.26 | 1.42 | 2.71 | 2.73 | 2.86 | |

Source: Citi Investment Research estimates

Likely impact of tower hive-off

Figure 3. Bharti gains from tower hive-off

| | Mar-07 | Dec-07 | Comments |
|--|--------|-------------|---|
| Net tower fixed assets (Rs bn) | 38 | 70 | |
| Number of towers | 34,000 | 50,000 | |
| | | FY09 | |
| Bharti's EBITDA impact assuming 1.5x tenancy and 50k rental (Rs m) | | (4,461) | |
| EBITDA margin impact | | -1.6% | |
| Depreciation reduction (Rs m) | | 5,600 | Assuming 8% of current net fixed assets |
| Net gain at EBIT level (Rs m) | | 1,139 | |

Source: Citi Investment Research estimates

Wholesale Voice - Strong volume growth but hit by pricing pressures

Figure 4. Long distance voice parameters

| Rs m | 1Q07 | 2Q07 | 3Q07 | 4Q07 | 1Q08 | 2Q08 | 3Q08 | Remarks |
|--------------------------|-------|-------|-------|--------|-------|--------|--------|--|
| NLD minutes | 2882 | 3628 | 4429 | 5004 | 5856 | 6774 | 7898 | Led by lowering of NLD tariffs |
| ILD minutes | 753 | 882 | 1059 | 1194 | 1243 | 1345 | 1591 | Sharp increase in usage |
| Revenue | 7,064 | 8,362 | 9,306 | 10,156 | 9,210 | 10,048 | 11,346 | |
| EBITDA | 2,750 | 3,367 | 4,002 | 3,640 | 3,169 | 3,462 | 3,652 | |
| EBITDA margin (%) | 38.9 | 40.3 | 43.0 | 35.8 | 34.4 | 34.5 | 32.2 | Competitive intensity results in margin pressure |
| EBITDA / LD minutes (Rs) | 0.76 | 0.75 | 0.73 | 0.59 | 0.45 | 0.43 | 0.38 | |

Source: Citi Investment Research estimates

Fixed Line - Cherry picking results in steady margin expansion

Figure 5. Fixed line and broadband parameters

| Rs m | 1Q07 | 2Q07 | 3Q07 | 4Q07 | 1Q08 | 2Q08 | 3Q08 | Remarks |
|--------------------|---------|---------|---------|---------|---------|---------|---------|---|
| Revenue | 5,182 | 5,244 | 5,984 | 6,044 | 6,513 | 7,023 | 7,307 | |
| EBITDA | 1,193 | 1,069 | 1,613 | 1,727 | 2,100 | 2,790 | 3,173 | |
| EBITDA margin (%) | 23.0 | 20.4 | 27.0 | 28.6 | 32.2 | 39.7 | 43.4 | Sharp increase in margins due to rising opex leverage |
| ARPU | 1202 | 1115 | 1198 | 1112 | 1121 | 1150 | 1140 | ARPU remains stable |
| Coverage of towns | 92 | 94 | 94 | 94 | 94 | 94 | 94 | |
| Number of DSL subs | 383,000 | 473,070 | 550,000 | 593,230 | 652,818 | 705,512 | 751,470 | |

Source: Citi Investment Research

Figure 6. Enterprise (Corporates) business parameters

| Rs m | 1Q07 | 2Q07 | 3Q07 | 4Q07 | 1Q08 | 2Q08 | 3Q08 | Remarks |
|-------------------|-------|-------|-------|-------|-------|-------|-------|----------------|
| Revenue | 1,969 | 2,148 | 2,422 | 2,511 | 2,730 | 3,423 | 3,290 | |
| EBITDA | 936 | 907 | 1,092 | 1,257 | 1,159 | 1,435 | 1,377 | |
| EBITDA margin (%) | 47.5 | 42.2 | 45.1 | 50.1 | 42.5 | 41.9 | 41.9 | Stable margins |

Source: Citi Investment Research

Bharti Airtel

Company description

Bharti Airtel, through its group companies, provides cellular-phone services in all the 23 telecom circles of India. The group also provides fixed-line phone services, broadband, long-distance and enterprise services. The company is listed on The Stock Exchange, Mumbai (BSE) and The National Stock Exchange of India Limited (NSE). Major shareholders are Bharti Telecom, SingTel and Vodafone.

Investment strategy

We rate Bharti Buy/Low Risk (1L). We believe continued robust wireless market expansion in India and Bharti's ability to capture this growth profitably will be a recurring theme. We estimate FY07-10 earnings CAGR of 36%, more than double the broader market. We believe that competitive pressures, though intense, will remain rational as low revenue yields and moderate EBITDA margins leave little room for disruptive pricing. Additionally, most regulatory concerns are behind us and 3G recommendations, though discomfoting, cannot derail the growth path, in our view. The company has yet to realize the benefits of economies of scale, and we expect a slight strengthening of margins over the next 2-3 years. We also expect the towerco hive-off (Bharti Infratel) to be a value accretive looking beyond the immediate impact on margins, given Bharti's stated intentions to be a minority stake owner in the towerco.

Valuation

Our 12-month forward target price of Rs1,200 is based on Sep-08 core DCF of Rs1,010 and a towerco option value of Rs170. 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 21.5x, P/CEPS of 14.2x and EV/EBITDA of 12.5x.

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.

Appendix A-1

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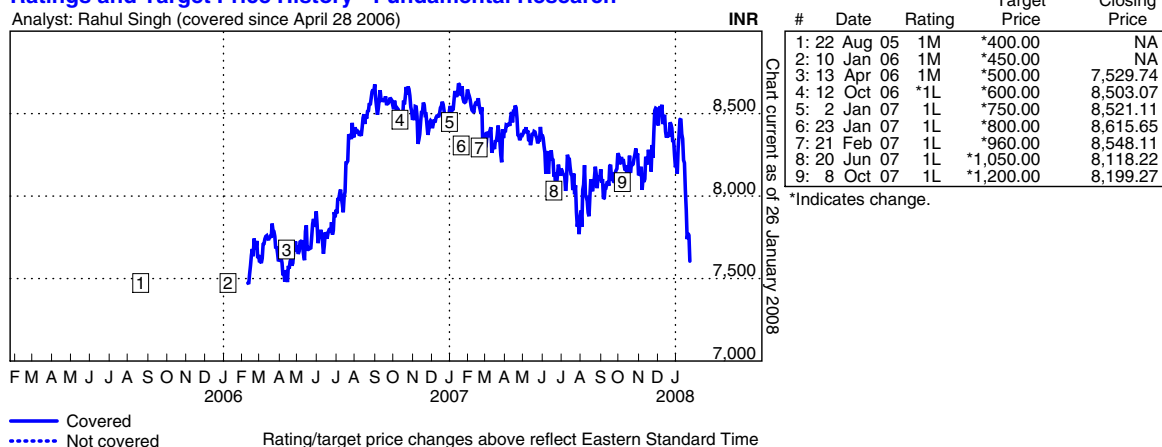
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Analyst: Rahul Singh (covered since April 28 2006)



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