EQUITY RESEARCH **June 29, 2007**

INITIATING COVERAGE

Mahanagar Telephone Nigam Limited Sell

Share Data

Market Cap	Rs. 101.15 bn
Price	Rs. 160.55
BSE Sensex	14650.51
Reuters	MTNL.BO
Bloomberg	MTNL IN
Avg. Volume (52 Week)	0.74 mn
52-Week High/Low	Rs. 171.6/127.8
Shares Outstanding	630 mn

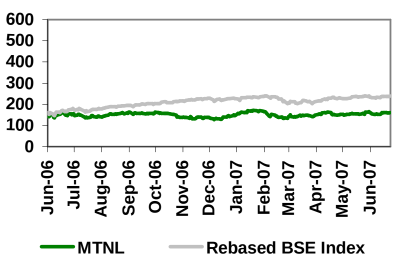
Valuation Ratios

Year to 31 March	2008E	2009E
EPS (Rs.)	8.7	9.5
+/- (%)	-0.4%	10.0%
PER (x)	18.6x	16.9x
EV/ Sales (x)	1.9x	1.8x
EV/ EBITDA (x)	8.9x	7.9x

Shareholding Pattern (%)

Promoters	56
FIIs	9
Institutions	23
Public & Others	12

Relative Performance



Losing Ground

Mahanagar Telephone Nigam Limited (MTNL) is currently providing telecommunication services in Delhi and Mumbai. The Company has 3.9 mn Wireline subscribers, 2.7 mn GSM subscribers and 1.7 mn broadband subscribers. Wireline business, which contributes close to 71% of revenues (standalone), is continually declining due to substitution by mobile services. In addition, the Company is facing strong competitive pressure in mobile and broadband segments. To counter this, the Company is putting in place Triple play strategy of bundled telephone, IPTV & broadband services and targeting lower penetrated international markets. However, we do not see any upside for the stock due to

Key Figures

Year to March	FY05	FY06	FY07E	FY08E	FY09E	CAGR (%)
(Figures in Rs mn, except per share data)						(FY06-09E)
Net Sales	55,886	55,721	51,542	52,830	54,679	-0.9%
EBITDA	13,644	8,524	10,154	11,359	12,850	22.8%
EBITDA Margins	24.4%	15.3%	19.7%	21.5%	23.5%	
GSM Subscribers	0.9	1.9	2.7	3.9	5.5	68.3%
Basic cum WLL subscribers	4.3	4.0	3.9	3.8	3.6	
Internet Subscribers	1.0	1.4	1.8	2.3	3.0	
Postpaid GSM ARPU	481	311	303	292	288	
Prepaid GSM ARPU	351	277	173	154	138	
Fixed line ARPU	813	799	713	650	599	
Broadband ARPU	531	582	442	415	384	
Per Share Data (Rs.)						
EPS	15.0	9.7	8.7	8.7	9.5	-0.7%
PER (x)	10.7x	16.6x	18.5x	18.6x	16.9x	

- We expect EBITDA to grow at a CAGR of 22.8% through FY06-09E driven by reduction in interconnect cost, license fees and lower SG&A.
- At the current price of Rs. 160.6, the stock is trading at a forward PE of 18.6x FY08E and 16.9x FY09E.
- Our target price of Rs.139 is based on a forward PE of 16x and FY08E EPS of Rs.8.7 per share, and represents a downside of 13.4% from current levels. We initiate coverage with a Sell as the Company is losing wireline subscriber base, has presence in only two circles, and is facing stiff competition from pan India telecom operators.

Rationale

Limited presence

Lack of pan India presence

MTNL has presence only in 2 circles (Delhi and Mumbai) out of 23 circles which place the Company at a disadvantage as far as pan India players like Bharti Airtel and Reliance Communications are concerned. MTNL remains a relatively small player in the Indian telecom space with a market share of 3.3%. Lack of pan India presence also limits the growth opportunity of the Company, given that a large portion of the telecom growth in India is expected to come from the under-penetrated semi urban/ rural areas.

Churn in wireline subscribers

Reducing wireline subscriber base

MTNL has been facing significant attrition of its wireline subscribers over the past few quarters on account of growing affordability of mobility services. Wireline revenues account for a 71% (standalone) of Company's revenues. Even if the number of wireless subscribers is increasing and the Company expects mobility revenues to grow at a rapid pace, wireless revenues account for only 15% (Standalone) of the Company's revenues. Hence, a continuous fall in wireline subscribers remains an area of concern.

Limited Spectrum

Indian telecom market is spectrum starved which in turn leads to congestion of network and lower subscriber expansion. In order to expand its 3G and broadband services, MTNL will require increase in spectrum. Lack of spectrum availability could in turn effect our rating assumption.

Reduction in Access Deficit Charges (ADC)

Reducing ADC leads to higher tariff rates

Recently announced reduction in ADC paid by cellular operators to wireline operators may force MTNL to increase its tariffs as it would not be able to subsidize its services. It would further increase the churn in the wireline subscribers.

Increasing employee cost

MTNL's employee cost accounts for ~35% of the Company's revenue (as against 5%-7% of other Telecom companies) which in turn puts pressure on the margins. Employee cost is expected to increase in future due to wage revision for all Public Sector Units. Increasing employee cost will negatively affect the rating.

Strengths

Next Generation Services

MTNL is putting in place Triple play strategy with launch of IPTV. Through bundled telephone, IPTV and broadband services, we expect MTNL to achieve reduced churn in wireline services. Further MTNL is expected to be one of the first companies that would be ready with 3G Network to provide services like video-on-demand on mobile. However, private players are expected to gain market share based on superior service and wider reach.

Increase in international bandwidth

Exploiting International Opportunities

MTNL is planning a new project for laying submarine cable from India to South East Asia and Middle East, with ultimate intent to extend eventually to the USA and Europe. The company's project will be run by Millennium Telecom Limited (MTL), a subsidiary of MTNL, in which Bharat Sanchar Nigam Limited (BSNL) has 49% stake. The project will help the Company to get international bandwidth to support its own network demand, as well as to lease it to others at very competitive rates.

Global Expansion

In order to capture the lower penetrated international markets, MTNL is currently in acquisition talks with Sri Lanka's premier telecom operator Suntel. Suntel is the largest fixed-line competitor to incumbent Sri Lanka Telecoms (SLT) with a subscriber base of around 300,000 and also has presence in the CDMA space. MTNL has also placed a bid for 26% equity stake in Telkom Kenya which has a subscriber base of 300,000. However, these expansion are not very significant in size.

Reduced interconnect costs led to reduced tariffs

Lower interconnect costs

Lately, MTNL has been able to reduce it's interconnect costs led by lower charges by BSNL on NLD traffic it carries for MTNL. Moreover, MTNL acquired a NLD license and entered into arrangement with Videsh Sanchar Nigam

Limited (VSNL) for long distance tariff between Delhi and Mumbai. Further, reduction on this front will help the Company to provide services at reduced rates and thus decrease the wireline churn.

Tax refunds

MTNL won tax refund cases of around Rs. 14 bn on account of disallowance of license fee and the Company expects to earn Rs. 4 bn of accrued interest on it. The Company will get the amount in the forth coming years. The ruling will further help the Company to save around Rs. 1 bn each year. This will increase net cash in the books of the Company, raising prospects for higher dividend pay out.

Huge cash reserves will help the Company in meeting its expansion plan

Surplus land and huge cash reserves

The Company is having surplus land and is planning to lease it out by way of long term lease or revenue sharing arrangements. For example the Company has over 50 acres of land in Noida which would fetch around Rs. 9 bn. To unlock the land value, MTNL is in talks with builders to develop commercial properties on the large tracts of land. The Company also has huge surplus cash which will help the Company to meet capital expenditure needs, grow inorganically and pay high dividend.

Outlook

Target price of Rs. 139, downside of 13.4% from current level

MTNL is a state owned provider of telecommunications services, with the Government of India having 56.25% share in the Company. Presently the Company is facing rapid deterioration in the wireline subscribers. To curb the attrition, MTNL plans to widen its mobile and broadband customer base. Moreover the Company would soon introduce 3G and IPTV services bundled with existing services. Although we see limited upside in valuation due to presence in only 2 of the 23 telecom circles and inability to compete against stronger pan India telecom operators like Bharti and Reliance.

At the current price of Rs. 160.55, the stock trades at a forward PE of 18.6x estimated FY08 earnings and 16.9x estimated FY09 earnings. Our Target price is Rs. 139 which represents a downside of 13.4% from the current level. We recommend MTNL to be a Sell. Our target price has been arrived using a forward PE of 16x and FY08E EPS of Rs. 8.7 per share.

Company Background

Mahanagar Telephone Nigam Limited (MTNL) was incorporated in 1986. The Company is a state-owned provider of telecommunications services, with the Government of India having 56.25% share in the Company.

MTNL provides a wide range of services like GSM, CDMA, Integrated Services Digital Network (ISDN), I-NET, Voice mail service, National and International trunk services, Internet and Broadband services. The Company presently provides services in Delhi and Mumbai with the subscriber base of around 6.7 mn. With 58,000 strong workforce, 492 state of the art digital exchanges and 1,375 km. of optical fiber the Company has unparallel infrastructure in Delhi and Mumbai. The Company has 6.7 mn wireless and wireline subscribers and 1.8 mn internet subscribers. MTNL's blended ARPU is Rs. 508 and broadband ARPU is Rs. 442.

MTNL has two wholly owned subsidiaries viz. Millennium Telecom Ltd. (MTL) at Mumbai and Mahanagar Telephone Mauritius Ltd. (MTML) at Mauritius. The Company also has a joint venture in Nepal by the name United Telecom Ltd.

(UTL), with Telecom Consultants of India (TCIL), Videsh Sanchar Nigam Limited (VSNL) and Nepal Ventures Pvt. Ltd (NVPL), to provide Wireless Local Loop (WLL) based basic telecom services in Nepal. All these add to the global presence of the Company. The Company got listed on New York Stock Exchange in 2001.

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