

## Company

7 September 2010 | 10 pages

# Reliance Communications (RLCM.BO)

 Equity   
 Estimate change 

## Sell: Weak Wireless Momentum

- Earnings adjusted to reflect tough environment** — FY11-12E EBITDA down 5% and FY11E net debt lowered to Rs311bn factoring 1Q results. Rs165 TP remains unchanged with core business valued at Rs125/share based on 7.1x Sep-11 EV/EBITDA (Mar-11E earlier); at a 15% discount to Bharti. Towerco value (net of core tenancy) is valued at Rs40/share. Corporate action related to stake sale remains the key upside risk.
- GSM traffic – goes back to the incumbents** — The fickle GSM traffic of multi-SIM subs has now more-or-less reverted back to the incumbents, resulting in a lackluster mins growth for the new GSM players. RCOM's traffic grew 1% qoq in 1Q on the back of a 5% growth in 4Q compared to the 10% growth witnessed by the incumbents in the same period. It however has managed to maintain its rev/min at 44p (now in-line with the industry). As a result while we cut FY11-12E traffic by 3-4%, overall wireless EBITDA is down only 2% over the same period.
- B/S deleveraging hits a roadblock** — RCOM's net debt stands at Rs285bn post 3G payment. With tower sale to GTL Infrastructure not materializing, the company now plans to pursue other options given leverage remains uncomfortably high (FY11E Net debt/EBITDA at 4.1x) especially when accompanied with the business risks. Focus on sweating existing assets (FY11E capex guidance at Rs30bn) will however slightly help.
- Global business – the only silver lining** — Though 1Q global revenue and EBITDA was down 11% and 7% qoq respectively, this was primarily due to one-off revenues in 4Q related to NLD and higher mkt spend on global calling cards in 1Q. Resumption of corporate spend and new contract sign-ups should benefit as the global economy continues to improve.

<b>Sell/Medium Risk</b>	<b>3M</b>
Price (07 Sep 10)	Rs163.75
Target price	Rs165.00
Expected share price return	0.8%
Expected dividend yield	0.9%
<b>Expected total return</b>	<b>1.7%</b>
Market Cap	Rs337,984M US\$7,262M

### Price Performance (RIC: RLCM.BO, BB: RCOM IN)



### Statistical Abstract

Year to	Net Profit	Diluted EPS	EPS growth	P/E	P/B	ROE	Yield
31 Mar	(RsM)	(Rs)	(%)	(x)	(x)	(%)	(%)
2008A	55,097	26.69	70.8	6.1	1.2	22.3	0.5
2009A	61,477	29.79	11.6	5.5	0.8	17.2	0.6
2010E	48,450	23.47	-21.2	7.0	0.9	12.0	0.9
2011E	21,832	10.58	-54.9	15.5	0.8	5.5	1.2
2012E	27,847	13.49	27.6	12.1	0.8	6.7	1.2

Source: Powered by dataCentral

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Fiscal year end 31-Mar	2008	2009	2010E	2011E	2012E
<b>Valuation Ratios</b>					
P/E adjusted (x)	6.1	5.5	7.0	15.5	12.1
EV/EBITDA adjusted (x)	5.8	6.5	8.2	8.8	8.1
P/BV (x)	1.2	0.8	0.9	0.8	0.8
Dividend yield (%)	0.5	0.6	0.9	1.2	1.2
<b>Per Share Data (Rs)</b>					
EPS adjusted	26.69	29.79	23.47	10.58	13.49
EPS reported	26.69	29.79	23.47	10.58	13.49
BVPS	140.63	204.85	187.90	196.23	207.47
DPS	0.75	1.00	1.50	2.00	2.00
<b>Profit &amp; Loss (RsM)</b>					
Net sales	190,678	229,411	222,502	234,937	255,071
Operating expenses	-136,743	-175,924	-181,461	-200,204	-212,101
<b>EBIT</b>	<b>53,935</b>	<b>53,487</b>	<b>41,041</b>	<b>34,733</b>	<b>42,970</b>
Net interest expense	3,998	7,867	11,863	-11,002	-12,029
Non-operating/exceptionals	0	0	0	0	0
<b>Pre-tax profit</b>	<b>57,933</b>	<b>61,354</b>	<b>52,904</b>	<b>23,731</b>	<b>30,941</b>
Tax	-2,836	123	-4,454	-1,898	-3,094
Extraord./Min.Int./Pref.div.	0	0	0	0	0
<b>Reported net income</b>	<b>55,097</b>	<b>61,477</b>	<b>48,450</b>	<b>21,832</b>	<b>27,847</b>
Adjusted earnings	55,097	61,477	48,450	21,832	27,847
Adjusted EBITDA	81,989	92,875	78,868	75,103	84,604
<b>Growth Rates (%)</b>					
Sales	31.8	20.3	-3.0	5.6	8.6
EBIT adjusted	65.7	-0.8	-23.3	-15.4	23.7
EBITDA adjusted	43.3	13.3	-15.1	-4.8	12.7
EPS adjusted	70.8	11.6	-21.2	-54.9	27.6
<b>Cash Flow (RsM)</b>					
<b>Operating cash flow</b>	<b>106,390</b>	<b>59,756</b>	<b>86,325</b>	<b>61,496</b>	<b>63,613</b>
Depreciation/amortization	28,054	39,388	37,827	40,370	41,634
Net working capital	2,563	-33,243	11,911	-11,709	-17,897
<b>Investing cash flow</b>	<b>-212,034</b>	<b>-255,510</b>	<b>-42,191</b>	<b>-116,018</b>	<b>-25,994</b>
Capital expenditure	-212,034	-255,510	-42,191	-116,018	-25,994
Acquisitions/disposals	0	0	0	0	0
<b>Financing cash flow</b>	<b>86,190</b>	<b>138,951</b>	<b>-95,770</b>	<b>44,354</b>	<b>-16,673</b>
Borrowings	83,834	133,406	-104,150	60,000	0
Dividends paid	-1,742	-2,322	-3,483	-4,644	-4,644
<b>Change in cash</b>	<b>-19,454</b>	<b>-56,804</b>	<b>-51,636</b>	<b>-10,168</b>	<b>20,946</b>
<b>Balance Sheet (RsM)</b>					
<b>Total assets</b>	<b>774,593</b>	<b>1,022,070</b>	<b>880,746</b>	<b>950,034</b>	<b>957,235</b>
Cash & cash equivalent	117,431	109,724	48,585	36,271	57,216
Accounts receivable	27,224	39,618	33,380	39,156	42,512
Net fixed assets	523,126	727,053	715,395	709,485	698,138
<b>Total liabilities</b>	<b>460,021</b>	<b>592,718</b>	<b>485,449</b>	<b>537,549</b>	<b>521,547</b>
Accounts payable	156,213	159,718	158,855	150,955	134,953
Total Debt	258,217	391,623	287,473	347,473	347,473
<b>Shareholders' funds</b>	<b>314,573</b>	<b>429,352</b>	<b>395,297</b>	<b>412,485</b>	<b>435,688</b>
<b>Profitability/Solvency Ratios (%)</b>					
EBITDA margin adjusted	43.0	40.5	35.4	32.0	33.2
ROE adjusted	22.3	17.2	12.0	5.5	6.7
ROIC adjusted	13.2	8.6	5.1	4.6	5.2
Net debt to equity	44.8	65.7	60.4	75.4	66.6
Total debt to capital	45.1	47.7	42.1	45.7	44.4

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## Tough environment for new GSM launches

RCOM's traffic grew 1% in 1QFY11 after a lackluster 5% growth in the previous quarter compared to the healthy traffic trend witnessed by the incumbents in the same time period. While management indicated the reason for the low traffic growth in 1Q has been the removal of free mins from the system, we believe the tariff intervention undertaken by the incumbents in Oct last year resulting in traffic reversion also has had a part to play. RCOM traffic trend is also similar to DoCoMo (Mumbai/Mah); after witnessing a strong 18% growth in 3QFY10, the traffic growth for DoCoMo has fallen to 10% and 4% for 4Q and 1QFY11 respectively.

**Figure 1. RCOM has had divergent traffic trend v/s GSM incumbents in the last 2 quarters**

	Dec-08	Mar-09	Jun-09	Sep-09	Dec-09	Mar-10	June-10
Bharti	6.7%	5.7%	7.7%	2.1%	6.7%	12.8%	10.2%
Vodafone Essar	8.6%	6.0%	10.0%	6.1%	9.2%	12.7%	10.1%
Reliance	6.3%	3.7%	11.4%	1.4%	5.3%	5.1%	0.9%
Idea	10.8%	9.9%	10.2%	3.3%	14.9%	13.5%	13.0%

Source: Citi Investment Research and Analysis

The focus on removal of the free mins however has helped RCOM rev/min, which at 44p is now broadly in-line with the GSM incumbents.

**Figure 2. RCOM's rev/min now in-line with the GSM incumbents**

Rs/Min	Dec-08	Mar-09	Jun-09	Sep-09	Dec-09	Mar-10	June-10
Bharti	0.64	0.63	0.58	0.56	0.52	0.47	0.45
Vodafone Essar <sup>1</sup>	0.84	0.82	0.75	0.70	0.66	0.61	0.58
Reliance	0.61	0.60	0.58	0.47	0.45	0.44	0.44
Idea	0.64	0.63	0.58	0.56	0.51	0.47	0.44

Source: Citi Investment Research and Analysis, <sup>1</sup> For Vodafone please look at the trend rather than absolute number as it doesn't double count on-net mins

## Earnings revision

Our new estimates reflect the ongoing tough operating environment for the new entrants post the industry migrating to lower tariffs in Oct-09. However RCOM's lower-than-expected decline in rev/min partially offsets the lower traffic assumptions. As a result while we reduce FY11-12E traffic estimates by 3-4%, wireless EBITDA decline is more moderate at ~2%.

**Figure 3. Wireless estimate revision**

	FY11E			FY12E		
	Old	New	Change	Old	New	Change
Traffic (mins m)	420,662	410,146	-2.5%	487,968	467,566	-4.2%
Wireless EBITDA (Rs m)	52,188	51,367	-1.6%	56,799	55,795	-1.8%

Source: Citi Investment Research and Analysis estimates

**Figure 4. Earnings revision**

Rs m	FY11E			FY12E		
	Old	New	Change	Old	New	Change
Consol EBITDA	79,308	75,103	-5.3%	89,407	84,604	-5.4%
Net debt	326,568	311,202	-4.7%	312,959	290,257	-7.3%
EPS (Rs)	12.0	10.6	-12.2%	14.9	13.5	-9.5%

Source: Citi Investment Research and Analysis estimates

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## TP remains unchanged at Rs165

We value RCOM's core business at Rs125/share, based on 7.1x Sep-11E EV/EBITDA (Mar-11E earlier) i.e. at a 15% discount to Bharti's imputed multiple on its DCF. We believe that a discount to Bharti is justified, given:

1. Inherent risks in dual network
2. High leverage
3. Lower capacity utilization in GSM

We estimate the towerco value (net of core business) at Rs40/share.

## Quarterly Summary

Figure 5. Financial Summary

Rs m	Jun-09	Sep-09	Dec-09	Mar-10	Jun-10	Q/Q%	Y/Y%
Net Revenues	61,452	57,026	53,097	50,927	51,092	0.3	(16.9)
Access and IUC	(4,158)	(4,263)	(5,151)	(5,905)	(6,646)	12.5	59.9
Other operating exp	(29,082)	(29,142)	(26,635)	(25,947)	(25,060)	(3.4)	(13.8)
License Fees	(3,687)	(3,422)	(3,186)	(3,056)	(3,066)	0.3	(16.9)
EBITDA	24,525	20,199	18,125	16,019	16,320	1.9	(33.5)
PBT	19,475	6,475	13,648	13,306	2,276	(82.9)	(88.3)
PAT	17,208	8,214	11,645	11,383	2,995	(73.7)	(82.6)

Source: Company, Citi Investment Research and Analysis

Figure 6. Wireless Summary

Rs m	Jun-09	Sep-09	Dec-09	Mar-10	Jun-10	Remarks
Wireless Revenue	47,931	40,100	40,225	40,900	41,528	Rev/min offsets lackluster traffic growth
Net revenue	38,086	29,295	27,998	26,226	28,047	Increase in on-net mins
Wireless EBITDA	18,489	13,132	12,545	11,815	11,989	
Wireless EBITDA margin (%)	38.6	32.7	31.2	28.9	28.9	Maintained despite flat traffic growth
ARPU	210	161	149	139	130	
MoU	365	340	330	318	295	
Pre-paid as % of net adds	99.0	99.2	101.3	102.4	101.6	Ongoing trend
Non-voice revenue %	-	-	-	-	-	
Minutes of usage (bn min)	83.3	84.5	89.0	93.5	94.4	1% growth, lower than GSM incumbents
Revenue per min (Rs)	0.58	0.47	0.45	0.44	0.44	Flat rev/min versus 2-3p decline for GSM incumbents
EBITDA per min (Rs)	0.22	0.16	0.14	0.13	0.13	
Capex per min	1.1	7.5	2.5	0.4	2.0	

Source: Company, Citi Investment Research and Analysis

Figure 7. Global business Summary

Rs m	Jun-09	Sep-09	Dec-09	Mar-10	Jun-10	Remarks
NLD mins (m)	10,349	11,205	13,643	16,086	15,265	4Q benefited from one-off volumes
ILD mins (m)	2,209	2,165	2,823	2,656	3,123	Healthy increase with focus on global calling cards
Global Business Revenue	18,844	22,643	19,818	20,278	18,137	QoQ decline from one-offs in 4Q and higher mkt spend
Global Business EBITDA	4,515	5,227	4,194	3,555	3,317	
Margins (%)	24.0	23.1	21.2	17.5	18.3	
Net retention per LD min (Rs)	0.40	0.40	0.25	0.25	0.25	

Source: Company, Citi Investment Research and Analysis

Figure 8. Broadband Summary

Rs m	Jun-09	Sep-09	Dec-09	Mar-10	Jun-10	Remarks
Broadband revenues	6,842	7,700	7,045	6,798	6,763	
Broadband EBITDA	2,994	3,199	2,755	2,526	2,477	
Broadband EBITDA margin (%)	43.8	41.5	39.1	37.2	36.6	
ARPL (Rs)	1626	1794	1642	1551	1534	
Towns active (wireline only)	42	42	42	42	42	
Buildings directly connected (nos)	967,154	1,006,807	1,018,732	1,029,327	1,049,914	Sustained pace of rollout

Source: Company, Citi Investment Research and Analysis

## Reliance Communications

### Company description

RCOM is an integrated player in the Indian telecoms sector. It was listed on the Indian stock exchanges following the de-merger of Reliance Industries. RCOM is the second-largest player in the mobile segment, has an 80,000km-long India-wide optic-fiber network and owns the FLAG submarine cable network. RCOM has three business units: 1) Wireless, which includes a nationwide wireless network on CDMA and GSM; 2) Global Business comprising wholesale voice and data; and 3) Broadband for both retail and enterprise.

### Investment strategy

We rate RCOM Sell/Medium Risk (3M). While RCOM was able to show early signs of success in its GSM foray in 1QFY10, traffic growth has slowed in the last 2 quarters as its “scheme hunting” sub base, susceptible to churn/traffic migrated back to the incumbents as they matched the lower tariffs. In addition, the B/S remains exposed to high leverage as the tower sale to GTL Infra did not materialize.

### Valuation

Our target price of Rs165 comprises (i) core business value of Rs125 based on 7.1x Sep-11E EV/EBITDA, at 15% discount to Bharti's implied target multiple plus (ii) towerco value accretion of Rs40 based on long-term tenancy of 2.3. We believe some discount to Bharti on the core business valuation is justified on account of the inherent risks of dual network and higher leverage. Our towerco net value accretion of Rs40 is based on the following assumptions: 1) Long-term tenancy of 2.3 with captive tenancy of 1.6; 2) Capex recovery of 13%, 3) WACC of 11.3% and terminal growth rate of 3%; 4) Please note that the incremental value accretion to RCOM is calculated after netting off the contribution from the captive tenancy. Thus, it only reflects the value of the external revenues.

### Risks

Our risk-rating system, which tracks 260-day share price volatility, assigns a High Risk rating to RCOM. We however assign Medium Risk rating given the improvement in the B/S and the credit markets. Upside risks that could prevent the stock from achieving our target price include higher-than-expected market share gains in GSM and a stake sale in the core-business, for which board approval has already been given.

# Appendix A-1

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Covered since June 18 2010

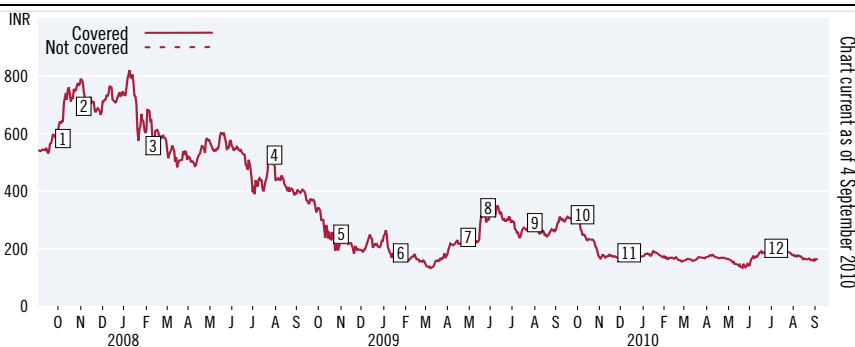


Chart current as of 4 September 2010

	Date	Rating	Target Price	Closing Price
1	8-Oct-07	*1L	*750.00	640.90
2	6-Nov-07	*2L	*835.00	745.40
3	12-Feb-08	*1L	*760.00	575.70
4	31-Jul-08	*2L	*530.00	500.05

	Date	Rating	Target Price	Closing Price
5	2-Nov-08	*2H	*270.00	220.70
6	26-Jan-09	*3H	*150.00	160.15
7	30-Apr-09	3H	*190.00	214.95
8	28-May-09	3H	*270.00	297.35

	Date	Rating	Target Price	Closing Price
9	2-Aug-09	*2M	*310.00	275.65
10	8-Oct-09	*3M	*210.00	246.30
11	12-Dec-09	3M	*160.00	183.65
12	8-Jul-10	3M	*165.00	187.95

\* Indicates change

Rating/target price changes above reflect Eastern Standard Time

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Data current as of 30 Jun 2010

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