Telcom Companies

August 14, 2010 Stock Market Scenario

Bharti Airtel: Sell

Reliance Communication: Sell

Idea Cellular: Sell

Validation

Our views about telecom companies have been validated. We had said in early 2008 that the valuation of Bharti at Rs 160,000 crores and Reliance Communications at Rs 100,000 crores made no sense given the level of competition that these companies faced. The operational result of these companies since then has supported our conjecture. The cash flow from operations has fallen for these companies. The ARPU (Average revenue per user) is in continuous decline. At the same time they have spent a significant sum on 3G licenses. The implementation of 3G networks would lead to even greater out flow. The stock market valuation that these companies had in early 2008 therefore was not justified in any way. QED

What is in store for future?

After gloating over our past success we come to more difficult task is predicting the future. While predicting the future is not accurate science by any means there are some conclusions that can be drawn from current conditions.

1. *Low ARPU regime will continue*: The low ARPU regime that has formed will continue. The number of players is more than 12. Most of these players are strong and many have global partners or controlled by global players. Others are part of Indian conglomerates. There is a feeling that the Indian market still has significant number of untapped customers. To gain these customers the telecom providers will continue to offer ever lower pricing schemes with lower monthly costs for customers.
2. *Capital expenditure will remain high*: The companies have spent a significant amount on 3G and BWA licenses. The total amount spent by the industry is in excess of Rs 100,000 crores. A significant amount would be spent on building this network. Bharti expects to spend about Rs 9,000 crores on 3G implementation in the current year.
3. *Low 3G revenue likely*: The 3G pricing would not be at a much premium as BSNL and MTNL are already providing these services at low costs. These prices would set a ceiling

for 3G services which would be difficult to cross. In addition CDMA players like Tata Indicom have introduced high speed wireless services at reasonable costs, which would form a ceiling to prices for 3G data services.

4. *High advertising expense for gaining customers:* The advertising costs for telecom players are significant as they have to occupy a significant media space to create a customer recall because of the intense clutter. In small cities all the roads are occupied by hoardings of telecom service providers. This high expense on advertising would only increase with launch of 3G services.
5. *Number portability sooner or later*: Number portability would reduce the pricing power of telecom companies even further, as there would be a movement to poach high paying customers serviced by rival telecom companies.
6. *High number of competitors*: The mergers between large players are limited by regulatory norms. This number is not going to come down any time soon.

Current Valuation

Reliance Communications	Share price: Rs 168 Market Capitalization: Rs 34,700 crores
Bharti Airtel	Share price: Rs 317 Market Capitalization: Rs 120,000 crores
Idea Cellular	Share price: Rs 73 Market Capitalization: Rs 23,900 crores

We are not quoting the price earning multiple as the picture about earnings is rapidly evolving with each quarter. We never had any confidence about the earnings of telecom companies as we felt that the depreciation figure was under stated significantly thereby inflating the earnings. The hope was that the capital expenditure would be some how be avoided in few years times leading to significant increase in cash flow. That never happened. The capital expenditure is only expected to grow in future.

Bharti deserves a special mention here because it has somewhat unique position. It is the largest telecom player and has significant international operations after acquisition of Zain. It also has the highest market capitalization. We feel that the stock price of Bharti does reflect the kind of competition it faces. Though it is the most efficient telecom player, it is not immune to competition. The high level of debt will be an added burden. Bharti's share prices are most inflated among the three large telecom players. Reliance Communication and Idea also face headwinds in their operations. Reliance Communications has shares have corrected a lot but they have some more way to go. Idea has even further scope of correction.

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