

 **Nifty Series**

September 16, 2008

Key Triggers
- Improving competitiveness to enable faster growth in subscriber base
- Aggressive network expansion to help Idea's entry into new service areas
- Idea-Spice Merger to help Idea to consolidate itself
Key Risks
- Launches in new circles could prove difficult being a late entrant
- Early stages losses in new circles

3 month stock view vis-à-vis	
Nifty	Underperformer
Expected price range – 3 Months	Rs.74 -Rs. 88

Post Breakout Levels	
Support	Rs.61
Resistance	Rs.108

Company Background

Idea Cellular Ltd (Idea), India's leading GSM Mobile Services operator is part of the Aditya Birla Group and is the fifth-largest cellular operator in India. It has licenses to provide cellular-phone services in 22 telecom circles in India. Currently its operations exist in 12 service areas viz., Delhi, Maharashtra, Goa, Gujarat, Andhra Pradesh, Madhya Pradesh, Chattisgarh, Uttaranchal, Haryana, UP, Himachal Pradesh, Mumbai, Rajasthan and Kerala. Idea has a customer base of over 28 million and currently reaches approximately 70% of India's telecom covered areas.

Recent Developments and Key Takeaways

[Increasing MoUs, entry into new circles and expansion into rural areas leading to growing subscriber base:](#)

Idea has witnessed a sharp rise in its subscriber base from 73 lakhs in FY07 to 2.4 cr in FY08. This rise has been accompanied by the increase in MoU (Minutes of Usage) from 364 minutes to 411 minutes in FY08. Also, Idea has been aggressively trying to increase its penetration into the rural areas. However, the average realised rate has been seeing a constant decline. With intense competition and operators offering lucrative schemes to users, the realisations could get hit further. Idea's ARPU registered a 12% fall in FY08 to Rs295, driven primarily by increasing competition and tariff cuts.

Idea saw a significant growth in MoU from 381 minutes per subscriber in Q1FY08 to 428 minutes per subscriber in Q1FY09. This alongwith sharp increase in subscriber base from 1.6 crs to 2.7 crs in Q1FY09 has helped them increase its market share to 9.6% in the wireless market as on June'08 and 13% as on Aug'08. Idea's ARPU registered a 13.1% fall from Rs.320 in Q1FY08 to Rs278 to in Q1FY09. Though the ARPU (Average Revenue Per User) is witnessing an annual decline, it is helping Idea to increase its subscriber base.

Company	Subscribers (In Crs)			MoU (In Mins)		ARPU (Rs.)		
	FY06	FY07	FY08	FY07	FY08	FY06	FY07	FY08
RCom	2.0	2.8	4.6	509	462	401	358	345
Bharti	2.0	3.7	6.2	475	507	474	427	370
Idea	0.7	1.4	2.4	361	411	391	334	295

Source: Company Reports

[Aggressive network expansion and various other initiatives to boost topline:](#)

Idea has licenses to provide cellular-phone services in 22 telecom circles in India and its operations exist in 12 service areas (incl. Mumbai). It is currently carrying out aggressive network expansion. Idea launched operations in the Mumbai circle in August'08. The Mumbai launch will strengthen its position as a leading telecom player in the country. Idea is investing Rs.800 cr for the Mumbai circle alone, of which around Rs.600 cr has been paid as telecom licence fee. The remaining amount will be invested to develop the circle's network and infrastructure. The Mumbai circle entry will help coverage area to go upto 70% of the total mobile subscriber base in the country. It also plans to roll out operations in Bihar and Jharkhand by Q2FY09 and Tamil Nadu in Q3FY09. As of Aug'08, Idea's market share for all-India wireless subscribers stands at 13%.

The fund infusion of Rs.3,500 cr by US-based Providence Equity Partners by way of picking up 20% stake in Aditya Birla Telecom (ABTL), a wholly owned subsidiary of Idea, will help Idea in meeting its expenses involved in expanding its network. ABTL owns a telecom licence for the Bihar service area and it will launch GSM services there in the next 3-4 months. However, Idea could face stiff competition from six other telecom operators there and so it could take time to establish a presence in the Bihar circle.

Idea plans to offer an integrated suite of services on a range of mid to high-end Nokia handsets in cooperation with the latter. This will offer consumers the combined advantage of easy to use devices with an enhanced experience in Internet services, content and browsing on Idea's high speed 2.75G EDGE networks across India. It also has plans to introduce several attractive offers and innovative tariff plans, on various devices, starting with the N96, in early September'08, targeted at a

varied cross-section of customers. These initiatives by Idea could enable them to expand their network, enter new service areas and build their subscriber base.

[Sharing of passive infrastructure – major cost saver for Idea:](#)

Idea has entered into a joint venture agreement with Vodafone Essar Limited (Vodafone) and Bharti Airtel Ltd (Bharti) to form an independent tower company Indus Towers Limited to provide passive infrastructure services in 16 circles of India. Bharti and Vodafone would hold approximately 42% each in Indus Tower and the balance 16% would be held by Idea. Indus Towers will be operational across 16 circles including Andhra Pradesh, Delhi, Gujarat, Haryana, Karnataka, Kerala, Maharashtra, Mumbai, Punjab, Rajasthan and Tamil Nadu. Idea Cellular is planning to hive off GSM towers and other passive infrastructure to its wholly owned subsidiary, Aditya Birla Telecom Ltd (ABTL) to monetise the assets and focus on core business. The towers will be further transferred to Indus Towers. This move will enable Idea to unlock shareholders value.

As of Aug'08, Idea's mobile network currently covers 29,000 towers of which 9,000 towers have been transferred to ABTL. It has a tenancy ratio of 1.32. Idea has entered into a deal to sell 20% stake in its subsidiary, Aditya Birla Telecom (ABTL) to Providence Equity Partners for a consideration of US \$640mn. The stake sale is through compulsorily convertible preference shares (CCPS). Idea holds a 16% stake in Indus through ABTL and ABTL owns the telecom universal access service (UAS) licence for the Bihar service area.

Sharing of passive infrastructure could result in significant savings in capex and would also reduce the opex, thereby adding intrinsic value to the stock. Idea's passive infrastructure accounts for almost 40-50% of total capex and we expect the rollouts to be significantly quicker, and this could help fight competition. We believe this move would have a positive impact on the company's earnings going forward.

[Update on Idea-Spice Merger:](#)

In June'08, Idea announced that it would be acquiring the Spice Group's stake of 40.8% in Spice Communications Ltd at a price of Rs.77.30 per share. Here 20% shares would be purchased from the Modis and the balance 20% would be picked up through an open offer (opening on September 17, 2008). It also would make a payment of approx Rs.544 cr to the Spice Group as non-compete fee. The swap ratio of merger of Spice with Idea was determined at 49 shares of Idea for every 100 shares of Spice. Idea would make a preferential allotment to TMI (TM International) of 46.47 cr equity shares at a price of Rs.156.96 per share representing 14.99% of Idea's equity capital post allotment. The combined entity would be the fifth largest mobile operator in the country, with over 30 mn subscribers, current presence in 13 circles, operations to commence shortly in 4 circles and combined market share of over 11%.

Through this merger, Idea could get an immediate entry in the circles of Punjab and Karnataka as Spice is fairly positioned in Punjab and Karnataka and has a market share of 22.5% and 10% in both circles respectively. Spice's overall market share between the 2 states stands at 15% as of June'08. It also possesses spectrum in the 900 MHz band in Punjab and Haryana, which enables them to incur lower capex costs for expansion of network, as the number of towers required would be less.

The benefits from this merger are:

- Idea to gain entry in the circles of Punjab and Karnataka, which account for 11% of India's total wireless subscribers
- Spice has 4.4 million subscribers as of April 30, 2008, i.e. 15.1% market share in the two service areas and is currently No.2 wireless operator in Punjab with a 22.5% market share as of June'08.
- Idea's operations in the 900 MHz GSM spectrum band will increase from the current 7 service areas to 9 service areas, driving economies of scale and operational synergies resulting in lower opex and capex.
- TMI's investment (cash infusion) of Rs.3,500 cr in Idea would help the latter to carry out its aggressive growth plans of rolling out services in Mumbai, Bihar, Orissa, and Tamilnadu (has received spectrum allocation in these circles).

Cash Outflow	Rs.Cr.
Purchase 20% shares from Modis @ Rs.77.30 per share	2175.9
Non-compete Fee	544.0
Open offer for 20% of Spice @ Rs.77.30 per share	1066.6
Total Cash Outflow	3786.6
Cash Inflow	
Preferential allotment to TNI @ Rs.156.96 per share	7293.9
Net Cash Inflow	3507.4

(Source: Capitaline, Company Website)

However, the Department of Telecom (DoT) has said that Idea will have to surrender its licence in Punjab and Karnataka without getting a refund of entry fee paid for these circles to avoid overlapping of service areas. While Idea Cellular had recently got licences for the two areas, Spice has been offering mobile services there. According to existing merger and acquisition rules, a single company cannot hold more than 10% stake in two different telecom firms in the same circle. DoT's decision also means that the Spice may also stand to lose money it paid for acquiring licences in Delhi, Andhra Pradesh, Haryana and Maharashtra circles as Idea Cellular already has operations in these circles.

Financial Performance

FY08:

Idea's net sales in FY08 witnessed a robust growth of 54.5% Y-o-Y from Rs.4,350 cr to Rs.6,719.9 cr on the back of strong volume growth of 68.6% to 2.7 cr subscribers and MoU increasing by 12.3% Y-o-Y to 411 minutes. The realized rate per minute fell from 84 paisa to 65 paisa. The rate per minute was down largely because of the decrease in national long distance and roaming rates and also due to softening on the processing fee part in general tariff plans.

The operating expenses saw a sharp rise of 53.9% from Rs.2,901.1 cr to Rs.4,466.2 cr in FY08 due to expiry of the period of 2% concession in licence fee for 7 service areas. Personnel expenses have dipped by 90bps Y-o-Y from 6% to 5.1% in FY08. Network operating expenses has sharply increased as a percentage of sales by 340bps to 15.6% in FY08. Subscriber Acquisition & Servicing Equipment has dipped sharply by 330 bps to 9.6% in FY08 due to the subscriber acquisition packages coming down to Rs.500 and Rs.300 from the initial cost of Rs.1,000. Advertisement & Business Promotion Expenses and Admin & Other Expenses have increased by 20 bps to 4.8% and 70 bps to 4.3% respectively in FY08. There has been an improvement in the operating profits by 52.8% to Rs.2,271.3 cr in FY08. However, the margins have fallen by 20bps to 33.7%. Other income has dipped by 17% Y-o-Y to Rs.17.5 cr in FY08 vis-à-vis Rs.20.9 cr in FY07. Interest costs have decreased by 9% to Rs.277.6 cr whereas depreciation has increased sharply by 34.3% to Rs.756.9 cr in FY08. Effective tax rate has seen a sharp rise of 511bps from 1.4% to 6.5% in FY08 due to higher deferred tax liability. The net profit has doubled to Rs.1,044.4 cr in FY08 thereby improving the margins by 410bps from 11.4% to 15.5% in FY08.

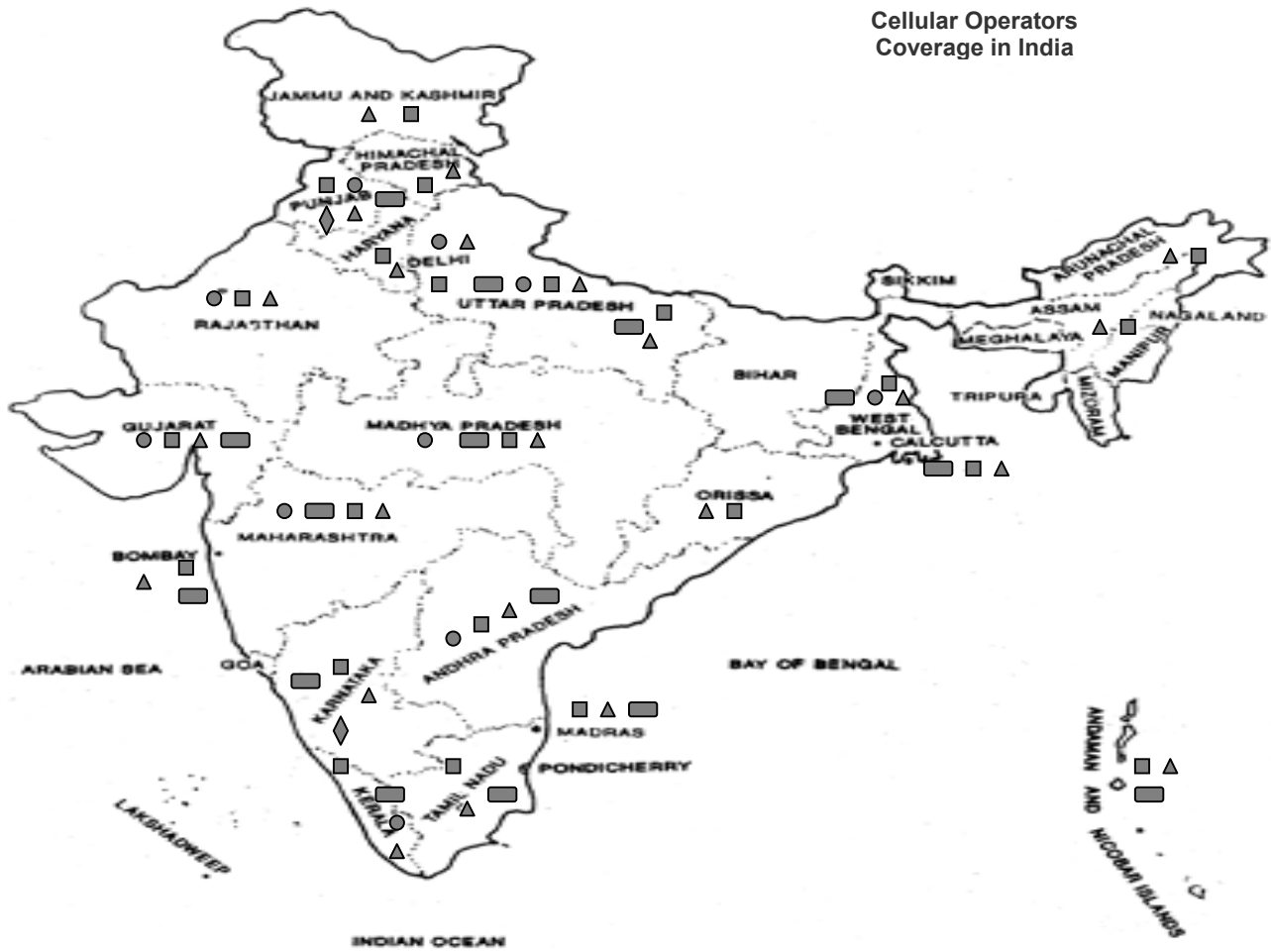
Q1FY09:

Idea registered a growth of 47% Y-o-Y to Rs.2,173.5 cr in net revenues in Q1FY09 on the back of strong volume growth. The operating expenses have sharply increased by 51.2% Y-o-Y from Rs.963.9 cr to Rs.1,457.7 cr in Q1FY09 due to sharp increase in network operating expenses by 440 bps from 12.9% to 17.3% in Q1FY09. Subscriber Acquisition, Servicing, Advertisement & Business Promotion expenses have sharply decreased by 450bps as a percentage of net sales from 17.3% to 12.9% in Q1FY09 whereas roaming and access charges have seen a rise of 190bps to 18.2% in Q1FY09. However, the operating profit has increased by 39.4% to Rs.715.8 cr in Q1FY09 whereby the operating margins skewed by 190bps to 32.9% in Q1FY09 due to the expiry of the license fee concession. Other Income dipped by 27.8% from Rs.80.9 cr to Rs.58.4 cr in Q1FY09. In Q1FY08, Idea made changes in financial reporting of interest expenses. Treasury income and gain/losses on forex are netted against interest costs and this has led to a sharp increase in interest costs from Rs.14.9 cr to Rs.152.6 cr in Q1FY09. Depreciation has increased by 45.7% to Rs.274.9 cr in Q1FY09. Tax outflow increased sharply from Rs.1.6 cr in Q1FY08 to Rs.29.7 cr in Q1FY09. The steep rise in interest expenses and tax outflow has dented the net profit margins by 1170 bps Y-o-Y from 26.3% in Q1FY08 to 14.6% in Q1FY09.

Subscriber Additions (In Crs)	April - August 08 (Cumulative)	Aug-08	Market Share (%)
Bharti Airtel	7.2	0.3	33.2
RCom	0.1	*	3.8
Vodafone	5.1	0.2	23.4
Spice	0.3	-0.1	1.6
Idea	2.8	0.1	13.0

* = Not Released

Source: COAI

**Cellular Operators
Coverage in India**

▲ Bharti (all 23 circles)

Metro - Kolkata, Chennai, Delhi, Mumbai; Circle A – AP, Gujarat, Karnataka, Maharashtra, TN; Circle B – Haryana Kerala, MP, Punjab, Rajasthan, UP (E & W), West Bengal, Andaman & Nicobar Islands; Circle C- Assam, Bihar, HP, North East, Orissa, J&K

■ RCom

Metro - Kolkata, Chennai, Delhi, Mumbai; Circle A – AP, Gujarat, Karnataka, Maharashtra, TN; Circle B – Haryana Kerala, MP, Punjab, Rajasthan, UP (E & W), West Bengal, Andaman & Nicobar Islands; Circle C- Assam, Bihar, HP, North East, Orissa

▭ Vodafone

Metro - Kolkata, Chennai, Delhi, Mumbai; Circle A – AP, Gujarat, Karnataka, Maharashtra, TN; Circle B – Haryana Kerala, Punjab, Rajasthan, UP (E & W), West Bengal, Andaman & Nicobar Islands

◆ Spice

Circle A – Karnataka; Circle B - Punjab

● Idea

Metro – Delhi; Circle A – AP, Gujarat, Maharashtra; Circle B – Haryana Kerala, MP, Rajasthan, UP (E & W); Circle C- Punjab

Conclusion

Growing subscriber base, rollouts in new circles and sharing of passive infrastructure are set to drive the growth of Idea. With combined Idea-Spice operations in 13 service areas and roll out in other four by end of CY08, we believe the deal is a step in the right direction and could boost Idea's national footprint. But the constant decline seen in ARPU and the average realised rate could be cause of concern for Idea. Also, Idea's rollout in the 3 new circles of UP, HP and Rajasthan could impact its profitability as Idea is a late entrant in these circles and hence it could be difficult to break-even.

Financials

Particulars (Rs in Crs)	FY06	FY07	FY08	FY09 (E)*
Operating income	2966.2	4366.4	6720.0	9368.3
PBIDT	1065.7	1465.3	2253.8	3101.9
PBIDTM (%)	35.6	33.2	32.6	32.8
Profit after Tax	211.3	502.3	1044.4	1140.5
PATM (%)	7.1	11.4	15.1	12.0
EPS	0.8	1.9	4.0	4.3
P/E (x)	101.3	41.0	20.0	18.3

* - Quick Estimates (not including Spice financials)

(Source: Annual Report, HDFC Sec Estimates)

Technical supports/resistances



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