8 February 2017

Update | Sector: Telecom

Idea Cellular

BSE SENSEX	S&P CNX
28,335	8,768

CMP: INR110 — Under review

Idea's Catch 22

Restrict investments or maintain equal promoter shareholding?

In our previous report on the Vodafone-Idea merger, we had assumed that post-merger both the companies could have equal shareholding rights at the firm level. However, we now see a possibility of Vodafone and Idea having equal rights at the promoter level. In this report, we lay out four possible scenarios that may unfold based on the current promoter shareholding patterns at Vodafone and Idea.

Promoter Vodafone UK holds 100% in Vodafone India, while promoter Aditya Birla Group (ABG) owns 42% of Idea Cellular. According to the SEBI regulation, the maximum percentage of promoter holding can be 75% of the total shareholding of the listed entity. This means if Vodafone and Idea decide to have equal shareholding at the promoter level, we could see rebalancing of stake to 37.5% each. Following are the four scenarios that could unfold as we mentioned earlier.

- **Scenario 1: Entity-wise equal stake (Vodafone – lower EV/EBITDA); rebalancing to 37.5% stake for the promoters:** Both promoters may have equal shareholding in the merged entity. However, given ABG's lower stake in Idea, it may have to infuse INR173b – of this, Vodafone may get ~INR55b and the rest will be infused in the merged entity.
- **Scenario 2: Entity-wise – Vodafone gets higher stake (equal EV/EBITDA); rebalancing to 37.5% stake for the promoters:** If Vodafone – a relatively large player than Idea – demands for a higher stake (equal EV/EBITDA), it should get a higher market cap of INR484b. Thus, to ensure equal promoter shareholding in the merged entity, ABG may have to shell out INR174b, of which Vodafone may get INR142b. This scenario, however, could defeat one of the key purposes of the merger – restricting cash outflow.
- **Scenario 3: Entity-wise equal stake (Vodafone – lower EV/EBITDA); no rebalancing – ABG thus gets a lower stake:** ABG may let Vodafone UK hold a higher stake in the merged entity by virtue of its 100% holding in Vodafone India v/s ABG' 43% stake in Idea. Thus, Vodafone may hold 50% in the merged entity (market value of INR396b), while ABG may hold 21% (similar to its current market value).
- **Scenario 4: Entity-wise – Vodafone gets a higher stake (equal EV/EBITDA); no rebalancing – ABG thus gets a lower stake:** If Vodafone demands a higher stake (equal EV/EBITDA), it will hold 55% in the merged entity (market value of INR484b). ABG, on the other hand, will hold 19% (similar to its current market value).

Stock Info

Bloomberg	IDEA IN
Equity Shares (m)	3,601
52-Week Range (INR)	128/66
1, 6, 12 Rel. Per (%)	45/13/-9
M.Cap. (INR b)	263.7
M.Cap. (USD b)	3.9
Avg Val, INRm	1123
Free float (%)	57.6

Financials Snapshot (INR b)

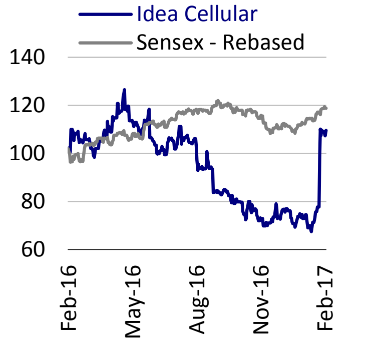
Y/E Mar	2016	2017E	2018E
Net Sales	359.8	355.5	358.9
EBITDA	130.3	101.5	96.4
NP	30.8	-22.6	-46.4
EPS (INR)	8.6	-6.3	-12.9
EPS Gr. (%)	56.5	-170.7	-250.7
BV/Sh. (INR)	71.6	65.3	52.4
RoE (%)	12.6	-9.2	-21.9
RoCE (%)	7.1	2.7	0.3
P/E (x)	8.6	-11.7	-5.7
P/BV (x)	1.0	1.1	1.4

Shareholding pattern (%)

As On	Dec-16	Sep-16	Dec-15
Promoter	42.5	42.2	42.2
DII	6.9	6.6	5.4
FII	24.3	25.1	24.1
Others	26.3	26.1	28.3

FII Includes depository receipts

Stock Performance (1-year)



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Merger beneficial only if it is concluded in about three quarters

Given the obstacles involved in this mega merger, it is difficult to predict how soon the regulatory overhang (e.g. revenue/spectrum caps and tax issue/penalties) will resolve. Previous instances of mergers of such scale suggest that the management focus usually shifts away from operations. Thus, in our view, if the Vodafone-Idea merger takes long to materialize, the current hyper-active competition in the telecom industry may provide peers room to eat into the subscriber share of both the companies. This too defeats the merger purpose of creating an entity that can take on the aggressive market players.

How could RJio react to consolidation?

There are two probable scenarios that may play out if the merger goes through. (1) It could force RJio to reconsider its competitive strategy, with the top two players likely to account for ~75% of industry revenues post consolidation. We believe the consolidation will allow the involved players (with healthy broadband coverage and FCF position) to match RJio's competitive intensity and thus protect churn. RJio subsequently may see limited market share gains due to high operating cost burn. (2) RJio could continue to aggressively compete in the market. However, it will be at the cost of earnings in the hope of eventual market share gain. We thus believe that competition may subside post the merger.

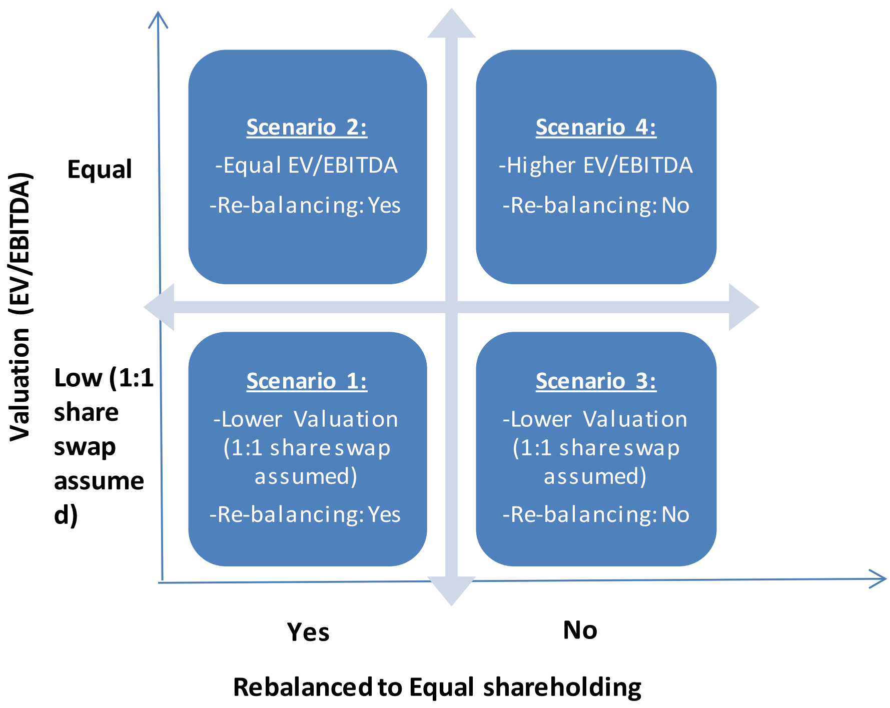
Note that we were expecting competition in the telecom market to remain intense for another 6-8 quarters. However, with 75% of the industry revenue share likely to be taken up by the top two players post consolidation, we now believe that competition may ease much sooner. We note that nearly 25% of the market is with smaller operators whose subscribers are most vulnerable to churn. Thus, existing large players may not need to employ low-price strategies to capture market share. Also, there are only 150m broadband users out of ~750m unique subscribers. This leaves a large pool of unserviced broadband users, which could be tapped, thereby improving industry ARPU. Also, while prices could continue declining, the price elasticity and high data capacity could drive higher ARPUs in the market. This, in our view, can be a win-win for all players.

Exhibit 1: Pro forma v/s Synergies (INR m)

1H FY17 Annualized	Idea	Vodafone	Idea + Vodafone	Idea + Vodafone + Synergy (annualized)	Comments
Revenue	187,869	225796	413,665	744,596	20% lower on 1HFY17 numbers
EBITDA	59143	66273	125,417	260,609	
EBITDA margin	31%	29%	30.3%	35%	500bp discount to Bharti India Wireless margin
EBIT	20,409	16,005	36,414	82,602	
EBIT Margin (%)	11%	7%	9%	11%	
Net Debt	559277	576,800	1,136,077	1,136,077	
Market Cap	396,088	396,088	792,177	792,177	
EV	955,366	972,888	1,928,254	1,928,254	
Total Assets	735,625	848,297	1,583,922	1,267,137	
EV/EBITDA	8.1	7.3	7.7	7.4	
Net Debt to EBITDA	4.7	4.4	4.5	4.4	
ROCE (post tax)	4%	3%	3%	9%	Assuming 30% tax and -10% net current asset for Vodafone
Share price	110	110	110	110	CMP
No of shares	3,601	3,601	7,202	7,202	Assuming Vodafone to get equal shareholding in overall entity

Source: Company, MOSL

Exhibit 2: Quadrant showcasing various scenarios



Scenario 1:
- Lower Valuation (1:1 share swap assumed)
- Re-balancing: Yes

Scenario 1: Entity-wise equal stake (Vodafone – lower EV/EBITDA); rebalancing to 37.5% stake for the promoters

1. **Step 1:** Assuming 1:1 share swap, Vodafone and ABG should get a 50% and 21% stake, respectively, in the merged entity. At this share swap, Idea is valued at 9.4x EV/EBITDA on FY17E, while Vodafone is valued at an implied EV/EBITDA of 8.6x FY17E, based on the assumption of equal shareholding of both entities.
2. **Step 2:** Subsequently, ABG will invest INR173b, of which Vodafone will get INR55b and the rest will be infused in the firm. This will ensure 37.5% stake for each promoter in the combined entity.
3. The combined entity, with cost savings of 500bp, should record EBITDA of INR260b in FY17E. This factors in revenue deceleration of 20% in 2HFY17, given competition from RJio (click here to view our previous report). With net capital infusion of INR119b, the overall enterprise value should stand at INR2,047b (7.9x EV/EBITDA at CMP of INR110).

Exhibit 3: Scenario 1: Entity-wise equal stake (Vodafone – lower EV/EBITDA); rebalancing to 37.5% for the promoters

Pre-merger			Post-merger						
Particulars			Step 1: Share swap (1:1)				Step 2: Each promoter gets equal shareholding		
Idea Shareholders	Share holding	Shares O/S (m)	Share holders	Share holding	Shares O/S (m)	Shares issued/ (reduced) (m)	Shares O/S (m)	Amount Infused/ (received)	Shareholding
Promoter holding	42%	1,529	Vodafone	50%	3,601	(497)	3,104	(54,660)	37.5%
Axiata	20%	712	Idea promoters	21.2%	1,529	1,577	3,106	173,487	37.5%
Public	38%	1,360	Axiata	9.9%	712	-	712		8.6%
Total	100%	3,601	Public	18.9%	1,360	-	1,360		16.4%
			Total	**100%**	**7,202**	**1,080**	**8,282**		**100%**

Exhibit 4: Scenario 1 – Merged Co.'s valuation post net equity infusion (INR m)

Idea Valuation		Vodafone	Valuation	Total	Equity infusion	Merged Co	Comments
EBITDA	101476	EBITDA	112,665	260,609		260,609	
Market Cap	396,088	Market Cap	396,088	792,177	118,827	911,003	Market cap post net equity infusion
Net Debt	559277	Debt	576,800	1,136,077		1,136,077	
EV	955,366	EV	972,888	1,928,254	118,827	2,047,081	
EV/EBITDA (x)	9.4	EV/EBITDA	8.6	7.4		7.9	

Source: Company, MOSL

Scenario 2:
- Equal EV/EBITDA
- Re-balancing: Yes

Scenario 2: Entity-wise, Vodafone gets a higher stake (equal EV/EBITDA); rebalancing to 37.5% stake for the promoters

1.) **Step 1:** Assuming Vodafone commands equal EV/EBITDA valuation of 9.4x on FY17E, it should get 1.2:1 share in an all share swap deal. This would provide Vodafone a 55% stake in the merged entity, while ABG may get a 19% stake.

2.) **Step 2:** Subsequently, ABG will infuse INR174b, of which Vodafone will receive INR142b and the rest will be infused in the entity to ensure 37.5% stake for each promoter.

3.) The combined entity, with cost savings of 500bp, should record EBITDA of INR260b in FY17E. With a higher stake to Vodafone on equal EV/EBITDA basis and net capital infusion of INR32b, the overall enterprise value would stand at INR 2,048b (7.9x EV/EBITDA at CMP of INR110).

Exhibit 5: Scenario 2 – Entity-wise, Vodafone gets a higher stake (equal EV/EBITDA); rebalancing to 37.5% for the promoters

Pre-merger			Post-merger						
			Step 1: Share swap 1.2:1					Step 2: Each promoter gets equal shareholding	
Idea Shareholders	Share holding	Shares O/S (m)	Share holders	Share holding	Shares O/S (m)	Shares issued/ (reduced) (m)	Shares O/S (m)	Amount Infused/ (received)	Shareholding
Promoter holding	42%	1,529	Vodafone	54.9%	4,399	(1,292)	3,107	(142,119)	37.5%
Axiata	20%	712	Idea promoters	19.1%	1,529	1,580	3,109	173,799	37.5%
Public	38%	1,360	Axiata	8.9%	712	-	712		8.6%
Total	**100%**	**3,601**	Public	17.0%	1,360	-	1,360		16.4%
			Total	**100%**	**8000**	**288**	**8288**	**31,680**	**100%**

Exhibit 6: Scenario 2 – Merged Co.'s valuation post net equity infusion (INR m)

Idea Valuation	(INR m)	Vodafone Valuation		Total	Equity infusion	Merged Co	Comments
EBITDA	101,476	EBITDA	112,665	260,609		260,609	
Market Cap	396,088	Market Cap	483,905	879,993	31,680	911,673	MCap post Net Equity infusion
Net Debt	559,277	Debt	576,800	1,136,077		1,136,077	
EV	955,366	EV	1,060,705	2,016,071	31,680	2,047,750	
EV/EBITDA	9.4	EV/EBITDA	9.4	7.7		7.9	

Source: Company, MOSL

Scenario 3:
- **Lower Valuation (1:1 share swap assumed)**
- **Re-balancing: No**

Scenario 3: Entity-wise equal stake (Vodafone – lower EV/EBITDA); no rebalancing – Idea thus gets a lower stake

1.) Step 1: Assuming 1:1 share swap, Vodafone and Idea should get a 50% and 21% stake, respectively, in the merged entity. At this share swap, Idea is valued at 9.4x EV/EBITDA on FY17E, while Vodafone is valued at an implied EV/EBITDA of 8.6x FY17E, based on the assumption of equal shareholding for both entities.

2.) We assume that ABG may not rebalance to equal holding between itself and Vodafone, given the significant capital infusion requirement of INR173b, which could defeat the primary purpose of the deal to reduce investments in the telecom sector.

3.) The combined entity, with cost savings of 500bp and EBITDA of INR260b (click here to view our previous report), should be valued at 7.4x EV/EBITDA at CMP of INR110 and enterprise value of INR1,928b.

Exhibit 7: Entity-wise equal stake (Vodafone lower EV/EBITDA); no rebalancing – Idea thus gets lower stake in merged entity

	Pre-merger		Post-merger		
	Pre-merger shareholding		Step 1: Share swap (1:1)		
Idea's shareholding	Shareholding	Shares O/S (m)	Particulars	Shareholding	Shares O/S (m)
Promoter holding	42%	1,529	Vodafone	50%	3,600.8
Axiata	20%	712	Idea promoters	21.2%	1,529
Public	38%	1,360	Axiata	9.9%	712
Total	**100%**	**3,601**	Public	18.9%	1,360
			Total	**100%**	**7,202**

Source: Company, MOSL

Exhibit 8: Scenario 3 – Merged Co.'s valuation

Idea Valuation		Vodafone Valuation		Merged Co
EBITDA (INR m)	101476	EBITDA (INR m)	112,665	260,609
Market Cap (INR m)	396,088	Market Cap (INR m)	396,088	792,177
Net Debt (INR m)	559277	Debt (INR m)	576,800	1,136,077
EV (INR m)	955,366	EV (INR m)	972,888	1,928,254
EV/EBITDA (x)	9.4	EV/EBITDA (x)	8.6	7.4

Source: Company, MOSL

Scenario 4:
- **Higher EV/EBITDA**
- **Re-balancing: No**

Scenario 4: Entity-wise, Vodafone gets a higher stake (equal EV/EBITDA); no rebalancing – Idea thus gets a lower stake

1.) Step 1: Assuming Vodafone commands equal EV/EBITDA valuation of 9.4x on FY17E, it should get 1.2:1 share in an all share swap deal. This would provide a 55% stake for Vodafone and 19% for ABG in the merged entity.
2.) We assume that ABG may not rebalance to equal holding between itself and Vodafone, given the significant capital infusion requirement.
3.) The combined entity, with cost savings of 500bp and EBITDA of INR260b (click here to view our previous report), should be valued at 7.7x EV/EBITDA at CMP of INR110 and enterprise value of INR2,016b.

Exhibit 9: Entity-wise, Vodafone gets a higher stake (equal EV/EBITDA); no rebalancing – so Idea gets a lower stake in the merged entity (share-swap: 1:2)

Pre-Merger			Post-Merger		
				Share swap ratio	1.2:1
Idea's shareholding	Shareholding	Shares O/S (m)	Particulars	Shareholding	Shares O/S (m)
Promoter holding	42%	1,529	Vodafone	54.9%	4,399
Axiata	20%	712	Idea promoters	19.1%	1,529
Public	38%	1,360	Axiata	8.9%	712
Total	**100%**	**3,601**	Public	17%	1,360
			Total	**100%**	**8,000**

Source: Company, MOSL

Exhibit 10: Scenario 4 – Merged Co.'s valuation

Idea Valuation (INR m)		Vodafone Valuation (INR m)		Merged Co.
EBITDA	101476	EBITDA	112,665	260,609
Market Cap	396,088	Market Cap	483,905	879,993
Net Debt	559277	Debt	576,800	1,136,077
EV	955,366	EV	1,060,705	2,016,071
EV/EBITDA (x)	9.4	EV/EBITDA (x)	9.4	7.7

Source: Company, MOSL

Financials and Valuations

Consolidated - Income Statement							(INR Million)
Y/E March	FY13	FY14	FY15	FY16	FY17E	FY18E	FY19E
Total Income from Operations	**224,577**	**265,189**	**315,709**	**359,809**	**355,503**	**358,882**	**392,414**
Change (%)	14.9	18.1	19.1	14.0	-1.2	1.0	9.3
Total Expenditure	**164,531**	**181,852**	**207,592**	**229,510**	**254,027**	**262,452**	**282,182**
% of Sales	73.3	68.6	65.8	63.8	71.5	73.1	71.9
EBITDA	**60,045**	**83,337**	**108,117**	**130,300**	**101,476**	**96,430**	**110,232**
Margin (%)	26.7	31.4	34.2	36.2	28.5	26.9	28.1
Depreciation	34,778	45,194	53,036	66,508	82,741	93,845	99,965
EBIT	**25,268**	**38,143**	**55,081**	**63,792**	**18,735**	**2,585**	**10,267**
Int. and Finance Charges	9,495	7,700	5,755	16,545	44,169	53,623	51,341
PBT bef. EO Exp.	**15,773**	**30,443**	**49,325**	**47,247**	**-25,434**	**-51,038**	**-41,074**
Share of profits of associates	0	0	0	0	4,270	4,623	0
PBT after EO Exp.	**15,773**	**30,443**	**49,325**	**47,247**	**-21,164**	**-46,414**	**-41,074**
Total Tax	5,664	10,765	17,396	16,447	1,405	0	0
Tax Rate (%)	35.9	35.4	35.3	34.8	-6.6	0.0	0.0
Reported PAT	**10,109**	**19,678**	**31,929**	**30,799**	**-22,569**	**-46,414**	**-41,074**
Adjusted PAT	**10,109**	**19,678**	**31,929**	**30,799**	**-22,569**	**-46,414**	**-41,074**
Change (%)	39.8	94.7	62.3	-3.5	-173.3	105.7	-11.5
Margin (%)	4.5	7.4	10.1	8.6	-6.3	-12.9	-10.5

Consolidated - Balance Sheet							(INR Million)
Y/E March	FY13	FY14	FY15	FY16	FY17E	FY18E	FY19E
Equity Share Capital	33,143	33,196	35,978	36,005	36,005	36,005	36,005
Total Reserves	111,073	132,073	194,314	221,670	199,101	152,686	116,617
Net Worth	**144,217**	**165,269**	**230,292**	**257,675**	**235,106**	**188,691**	**152,622**
Total Loans	140,438	206,350	268,591	415,031	573,284	603,380	604,486
Deferred Tax Liabilities	11,180	18,133	19,015	30,714	30,714	30,714	30,714
Capital Employed	**295,834**	**389,752**	**517,898**	**703,420**	**839,104**	**822,785**	**787,822**
Gross Block	467,357	516,970	618,207	986,766	1,194,745	1,269,745	1,344,745
Less: Accum. Deprn.	175,818	221,012	262,871	303,848	386,589	480,434	580,399
Net Fixed Assets	**291,539**	**295,958**	**355,336**	**682,918**	**808,157**	**789,311**	**764,347**
Goodwill on Consolidation	61	61	61	61	61	61	61
Capital WIP	8,811	114,194	51,405	60,986	60,986	60,986	60,986
Total Investments	**10,280**	**2,155**	**115,267**	**13,728**	**13,728**	**13,728**	**13,728**
Curr. Assets, Loans&Adv.	**53,092**	**53,206**	**82,598**	**68,807**	**56,722**	**74,083**	**69,444**
Inventory	726	683	710	1,065	881	985	1,056
Account Receivables	9,601	8,006	9,789	11,776	9,632	11,980	11,653
Cash and Bank Balance	1,429	1,881	15,537	7,818	279	8,020	1,459
Loans and Advances	41,336	42,636	56,562	48,148	45,930	53,098	55,275
Curr. Liability & Prov.	**67,949**	**75,823**	**86,769**	**123,081**	**100,551**	**115,385**	**120,744**
Account Payables	64,719	68,960	78,013	112,331	92,021	104,451	110,395
Provisions	3,230	6,863	8,756	10,750	8,530	10,933	10,350
Net Current Assets	**-14,857**	**-22,616**	**-4,171**	**-54,273**	**-43,828**	**-41,301**	**-51,300**
Appl. of Funds	**295,834**	**389,752**	**517,898**	**703,420**	**839,104**	**822,786**	**787,822**

E: MOSL Estimates

Financials and Valuations

Ratios

Y/E March	FY13	FY14	FY15	FY16	FY17E	FY18E	FY19E
Basic (INR)							
EPS	**2.8**	**5.5**	**8.9**	**8.6**	**-6.3**	**-12.9**	**-11.4**
Cash EPS	12.5	18.0	23.6	27.0	16.7	13.2	16.4
BV/Share	40.1	45.9	64.0	71.6	65.3	52.4	42.4
DPS	0.3	0.4	0.6	0.6	0.0	0.0	0.0
Payout (%)	11.5	7.9	8.1	8.4	0.0	0.0	0.0
Valuation (x)							
P/E			8.3	8.6	-11.7	-5.7	-6.4
Cash P/E			3.1	2.7	4.4	5.6	4.5
P/BV			1.1	1.0	1.1	1.4	1.7
EV/Sales			1.6	1.9	2.4	2.4	2.2
EV/EBITDA			4.8	5.1	8.2	8.9	7.9
Dividend Yield (%)	0.4	0.5	0.8	0.8	0.0	0.0	0.0
Return Ratios (%)							
RoE	7.4	12.7	16.1	12.6	-9.2	-21.9	-24.1
RoCE	5.9	7.5	8.2	7.1	2.7	0.3	1.3
RoIC	6.0	9.0	11.7	8.7	2.9	0.3	1.4
Working Capital Ratios							
Fixed Asset Turnover (x)	0.5	0.5	0.5	0.4	0.3	0.3	0.3
Asset Turnover (x)	0.8	0.7	0.6	0.5	0.4	0.4	0.5
Inventory (Days)	1	1	1	1	1	1	1
Debtor (Days)	16	11	11	12	10	12	11
Leverage Ratio (x)							
Current Ratio	0.8	0.7	1.0	0.6	0.6	0.6	0.6
Interest Cover Ratio	2.7	5.0	9.6	3.9	0.4	0.0	0.2
Net Debt/Equity	0.9	1.2	0.6	1.5	2.4	3.1	3.9

Consolidated - Cash Flow Statement **(INR Million)**

Y/E March	FY13	FY14	FY15	FY16	FY17E	FY18E	FY19E
OP/(Loss) before Tax	10,109	19,678	31,929	30,799	-22,569	-46,414	-36,069
Depreciation	34,778	45,194	53,036	66,508	82,741	93,845	99,965
Interest & Finance Charges	9,963	8,564	9,337	18,498	44,169	53,623	51,341
Direct Taxes Paid	-4,110	-6,384	-11,043	-10,789	0	0	0
(Inc)/Dec in WC	6,096	5,354	5,540	-3,429	-17,985	5,215	3,438
CF from Operations	**56,836**	**72,406**	**88,800**	**101,587**	**86,356**	**106,268**	**118,674**
Others	6,135	9,786	15,379	18,512	0	0	0
CF from Operating incl EO	**62,971**	**82,192**	**104,179**	**120,100**	**86,356**	**106,268**	**118,674**
(Inc)/Dec in FA	-34,766	-36,448	-41,576	-75,157	-207,980	-75,000	-75,000
Free Cash Flow	**28,205**	**45,744**	**62,603**	**44,943**	**-121,623**	**31,268**	**43,674**
Others	657	-29,194	-15,680	-54,772	0	0	0
CF from Investments	**-34,109**	**-65,642**	**-57,256**	**-129,928**	**-207,980**	**-75,000**	**-75,000**
Issue of Shares	248	263	37,374	175	0	0	0
Inc/(Dec) in Debt	-10,368	-15,936	52,355	-86,558	158,253	30,096	1,106
Interest Paid	-9,283	-7,682	-6,656	-8,505	-44,169	-53,623	-51,341
Dividend Paid	-250	-1,306	-2,792	-2,598	0	0	0
CF from Fin. Activity	-19,653	-24,661	80,280	-97,486	114,084	-23,527	-50,235
Inc/Dec of Cash	**9,209**	**-8,111**	**127,202**	**-107,315**	**-7,540**	**7,742**	**-6,561**
Opening Balance	1,521	10,729	3,543	130,745	7,818	279	8,020
Closing Balance	**1,429**	**1,881**	**15,537**	**23,430**	**279**	**8,020**	**1,459**

E: MOSL Estimates

NOTES

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