Idea - Spice acquisition: What an Idea!

Event Update

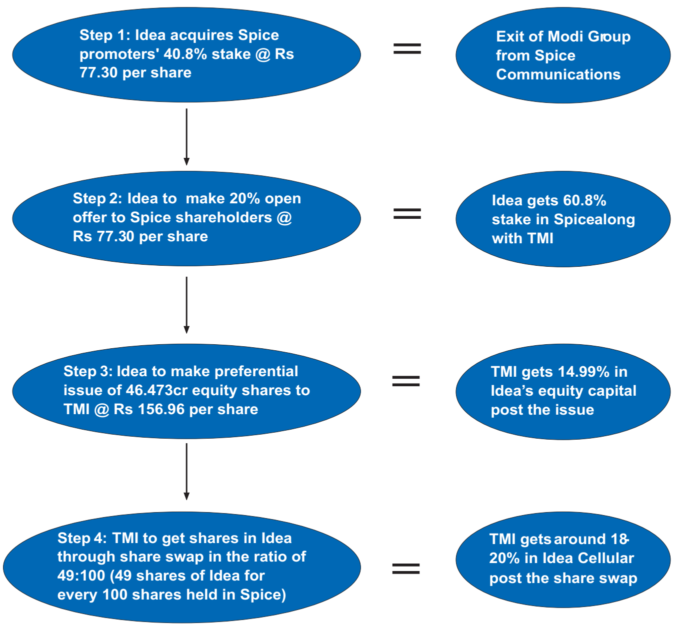
Idea Cellular, India's fifth-largest cellular services operator, has acquired the promoter, the Modi Group's, stake in Spice Communications, a regional operator with a presence in two circles, namely Punjab and Karnataka. Idea, along with Telecom Malaysia International (TMI) will now make an open offer for a further 20% stake in Spice, as required by Indian securities regulations. The combine will be the fifth-largest mobile operator in the country, with over 30mn subscribers, a presence in 13 circles with operations due to commence shortly in four more circles and a combined market share of over 11%.

The deal, while not leading to any changes in the pecking order in terms of market rankings (Idea standalone is the fifth-largest mobile operator, having overtaken Tata Teleservices in April 2008 and the Idea + Spice combine is also the fifth-largest operator, albeit a stronger one, behind BSNL), is the first sign of consolidation in the sector, which has seen very little over the past few years. However, we believe this is just a small step towards consolidation and will not lead to any major moves by any operator, given the current market shares, the slim possibility of any of the top six operators being acquired by each other and the lack of presence of any other attractive telecom asset in the country.

Contours of the deal

Idea Cellular will acquire the 40.8% stake of the promoter group in Spice Communications for a price of Rs77.30 per share. Apart from this, it will also make a payment of Rs544cr to the promoter group of Spice as non-compete fee. As per Indian securities laws, Idea will make an open offer along with TMI and its affiliates and associates for a further 20% stake in Spice Communications. The Boards of Idea and Spice have also approved the merger of Spice into Idea and the swap ratio has been determined at 49 shares of Idea for every 100 shares of Spice. Idea will make a preferential allotment to TMI of 46.473cr equity shares at a price of Rs156.96 per share, which represents 14.99% of Idea's equity capital post allotment. Idea expects to complete the transaction over the next six months.

Exhibit 1: Deal chronology



Source: Company, Angel Research

Benefits to Idea

The deal does seem expensive as it values Spice at an EV/EBITDA of nearly 30x CY2007 EBITDA and around 14x CY2009E EBITDA and the fact that the company is still loss-making (Rs59.2cr net loss in CY2007). However, it should be noted that in such deals, there is typically an acquisition premium involved and often, valuation ratios like P/E or EV/EBITDA take a backseat in light of the longer-term quantitative, qualitative and strategic benefits involved. We believe Idea in the long-term will benefit in several ways from the deal and it should be looked at from that perspective.

(1) Immediate accretion to subscriber base, market share gains and operating profitability

Through Spice, Idea's mobile subscriber base increases by over 17% to 30.6mn and its market share rises by 165bp to 11.2%. The company gets an immediate subscriber base in the circles of Punjab and Karnataka along with operating profits (EBITDA) of 23.3% (CY2007). It should be noted that if the company was to start operations on a greenfield basis in these circles, it would take several months to roll-out

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operations post the receipt of spectrum and most likely in excess of 2-3 years at least before the circles would break-even at the EBITDA level. Thus, in a sense, Idea is 'buying the gestation period' in terms of better profitability of newer circles (Punjab and Karnataka), which would otherwise take several years.

Exhibit 2: Idea + Spice - United, we stand!

	Subscriber base (Mn)	Market share (%)*	Rank
Bharti Airtel	66.8	24.5	1
RCOM	49.0	18.0	2
Vodafone-Essar	47.5	17.4	3
BSNL	37.0	13.5	4
Idea Cellular	**26.1**	**9.6**	**5**
Idea + Spice	**30.6**	**11.2**	**5**
Change	***4.5***	***1.6***	**-**
Tata Teleservices	25.5	9.3	6

*Source: COAI, AUSPI, Angel Research; Note: Subscriber data is at the end of May 31, 2008; * Excluding BSNL and MTNL CDMA-WLL subscribers*

2) Spice, a well-entrenched operator in its two circles of operations

Spice Communications is fairly well-placed in its two circles of operations, namely Punjab and Karnataka. In Punjab, one of India's richest states and having amongst the highest per capita incomes, Spice enjoys a 22.5% market share and is the second-largest player after Bharti Airtel. In Karnataka, on the other hand, even though the company is only the fifth-ranked operator out of six (10% market share), it has grown at a faster pace than the overall market and has gained nearly 200bp in market share over the past year. In fact, the difference between BSNL, the fourth-ranked operator and Spice is very small and it seems likely that the latter will overtake the PSU telecom major at this rate. In both these circles combined, Spice has an overall market share of over 15%, thus reflecting its fairly competitive positioning. In fact, over the past six months, Spice has managed to corner over 18% of the incremental market share in both these circles.

Exhibit 3: Spice's circle-wise details - Improving rapidly

(Sub. base, mn)	Dec	Jan	Feb	March	April	May	*Chg**
			Punjab				
Spice Comm.	2.3	2.4	2.5	2.6	2.6	2.7	*0.4*
Circle	10.6	10.9	11.3	11.6	11.9	12.1	*1.5*
Market share (%)	*21.9*	*22.0*	*22.1*	*22.1*	*22.3*	*22.5*	*0.6*
			Karnataka				
Spice Comm.	1.5	1.5	1.6	1.6	1.7	1.8	*0.3*
Circle	15.3	15.8	16.3	16.7	17.1	17.7	*2.3*
Market share (%)	*9.6*	*9.7*	*9.7*	*9.8*	*10.0*	*10.0*	*0.4*
			Total				
Spice Comm.	**3.8**	**3.9**	**4.1**	**4.2**	**4.4**	**4.5**	***0.7***
Circle	**26.0**	**26.8**	**27.6**	**28.4**	**29.0**	**29.8**	***3.8***
Market share (%)	***14.6***	***14.7***	***14.8***	***14.8***	***15.1***	***15.1***	***0.5***

*Source: COAI, AUSPI, Angel Research; * Change of May 2008 over December 2007*

3) Gaining access to spectrum in the 900 MHz band, enabling lower capex and opex

Spice, being amongst the first two operators in both Punjab and Karnataka, has spectrum in the 900 MHz band in both these circles. The 900 MHz band has greater propagation characteristics, thereby enabling lower capex costs for expansion of coverage area, as the number of towers and base stations required would be lesser than in the 1,800 MHz band. Thus, this is a positive for Idea, as after completion of the transaction, it will have 900 MHz spectrum allotment in 9 circles out of the 13 that it would operate in (excluding commencement of operations in Mumbai, Bihar, Orissa and Tamil Nadu including Chennai).

(4) TMI as a strategic investor

Arguably one of the biggest benefits for Idea Cellular on account of this deal would be gaining the expertise of TMI as a strategic investor. TMI would get a board seat and comes with significant experience in emerging market operations in countries like Sri Lanka, Pakistan, Malaysia, Indonesia and Bangladesh. TMI also has strong experience in operating 3G networks in other markets, which would be of help for Idea as and when it bids for 3G licences in India.

(5) Strong cash infusion, leading to a well-funded balance sheet

Idea Cellular, on account of this deal, will witness strong cash infusion to the tune of over Rs3,500cr (US $821mn) after paying for a further 20% stake in Spice through the open offer (assuming the response to the open offer is strong). As per the terms of the deal, Idea will pay the Spice promoters Rs77.30 per share for their 40.8% stake in Spice,

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as well as a non-compete fee of Rs544cr. Thus, the total inflow for the Modi Group will be around Rs2,720cr, translating into an effective per-share value of Rs96.63, which is at a whopping 126% premium to the last 6-month average share price of Spice. Thus, the deal is clearly a winning proposition for the Modi Group.

On the other hand, TMI will pay Idea Rs156.96 per share for 46.473cr shares that the former will issue to it, giving it effectively 14.99% of the post-issue share capital, thus not requiring TMI to make an open offer. The price to be paid by TMI is at a significant 58% premium to the closing share price prior to the announcement of the deal and a 41% premium to the last 6-month average share price of Idea. The total cash inflow for Idea on account of this issue will be a significant Rs7,294cr.

Exhibit 4: Cash Flow from the deal for Idea (Rs cr)

Cash Outflow	
Share purchase from Modis @ Rs 77.30 per share	2,175.9
Non-compete fee	544.0
Open offer for 20% of Spice @ Rs 77.30 per share	1,066.6
Total Cash Outflow	**3,786.5**
Cash Inflow	
Preferential share issue to TM @ Rs156.96 per share	**7,294.4**
Net Cash Inflow	**3,507.9**

Source: Company, C-line, Angel Research

It may also be recalled that Idea had 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, thereby monetizing its stake in Indus Towers, a joint venture formed between Idea Cellular, Bharti Infratel and Vodafone-Essar. It should be noted that Idea through ABTL holds a 16% stake in Indus, apart from owning the telecom universal access service (UAS) licence for the Bihar service area. Thus, after these two deals, Idea will not only become debt-free but will also become well-capitalised to invest in growth and expansion into existing and newer service areas. Notably, Idea has earmarked Rs10,000cr over the next 2 years for expansion plans.

The dilution effect

On account of this deal, Idea's equity capital will witness about 23% dilution. In terms of a chronological sequence, Idea will first make a preferential allotment of 46.473cr equity shares to TMI, giving it a 14.99% stake in the post-issue equity capital. After this, the next step for the final stage of dilution will involve swapping TMI's 39.2% stake in Spice for further shares in Idea in the determined swap ratio of 49 Idea shares for every 100 Spice shares held. This will lead to a further 13.25cr shares being issued and will take TMI's stake in Idea to 18.5%. The eventual stake of TMI will be in the range of 18-20%, depending on how many shares it purchases in the open offer along with Idea. However, it should be noted that this will not lead to an open offer for Idea shareholders, as the stake is increasing beyond 15% through a share-swap and not through an open market purchase of Idea's shares. The promoter's stake in Idea Cellular will fall to 47% from 57.7% currently.

Exhibit 5: Equity Dilution for Idea Cellular (Rs cr)

Current Equity Share Capital	2,635.4
Preferential issue to TMI	464.7
Sub-total	**3,100.1**
Issue to TMI for its stake in Spice through share swap (ratio 49:100)	132.5
Fully Diluted Equity Share Capital	**3,232.6**
Dilution (%)	**22.7**

Source: Company, C-line, Angel Research; Note: The shares issued to TMI through the share swap are assuming it does not purchase any of the shares tendered by minority shareholders in the open offer.

Our view

We view the deal with Spice favourably and even though it does seem as though the price that Idea is paying for Spice is a bit steep, it should be looked at in light of the benefits that the deal will give Idea over a longer-term time frame. Typically, such acquisitions are always made with a time-frame of at least a few years in mind, given the time taken for the synergies to be realised, cost savings, qualitative benefits to play out and EPS accretion. Undoubtedly, in the short-term, Idea's equity will see a 23% dilution, leading to lower EPS and its margins will also witness some pressure due to the lower profitability of Spice, but this can be viewed as 'newer circles' (Punjab and Karnataka) that are already profitable and going ahead, the situation can be improved with better execution skills and operating leverage. **We are working on our projections for Idea to factor in the effect after the merger with Spice. We view the deal as a long-term positive, even though a short-term negative impact cannot be ruled out. We maintain a Buy on the stock and our Target Price is under review.**

Analyst - **Harit Shah**