

PAKISTAN

Wateen Telecom

19 April 2010

Wateen Telecom Ltd.

(Shares in Mn)

Total Shares	417
IPO	110
Shares without Green Shoe	527
Green Shoe option	90
Shares with Green Shoe	617

Key Consolidated Balance Sheet value as of Dec 2009

Debt/Asset	57%
Debt/Equity	437%
BVPS	8.6
P/B at offer price of PKE10	1.2

Source: Company prospectus and presentation

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High Leverage and revenue stream volatility

Event

- Wateen Telecom is raising new capital of PKR1,100mn by offering additional 110mn shares with a Greenshoe option of a further PKR90mn by offering additional 90mn shares, both at a price of PKR10/share through IPO. Due to risks like high leverage and volatile revenue stream, we recommend investors to not subscribe to this public offer. We have highlighted key risks along with analysis of past operating performance.

Analysis

- The group:** Wateen Telecom is jointly owned by Warid Telecom International (79.8% holding) and Bank Alfalah Limited which in turn are backed by Abu Dhabi Group. Abu Dhabi group, being one of largest foreign investor groups of Pakistan, has a diversified portfolio of investments in Bank Alfalah Limited, United Bank, Warid Telecom, CNBC Pakistan and Al-Razi Healthcare. The group currently owns 92% of Wateen Telecom and the holding will dilute to 62% post IPO (inclusive of green shoe option).
- The company:** Wateen Telecom has been operating in telecom and data services sector of Pakistan since May 2005. The company has a diversified product portfolio including largest commercial 3.5 GHz WiMAX network covering 22 cities, fiber broadband services, satellite services, managed solutions, managed capacity, and LDI services. The company is market leader in WiMAX segment (above 60% market share) and has around 20% market share in total Broadband market.
- Products** The company currently offers both retail and wholesale products. Wholesale products include Long Distance and International (LDI) telephony, national transmission network (fiber and VSAT services) and telecom infrastructure to other telecom carriers in the country. Wateen has been providing services like Broadband internet (wireless and cable), telephony, multimedia, TV broadcast services and value added services to retail clients on back of its +10,000Km optical fiber and WiMAX networks. Currently wholesale segment contributes up to 70% of total revenues which is expected to decline to 50% in long term.
- Reasons of offering:** The IPO proceeds will be utilized for two main purposes, 1) repayment of financial liability amounting to PKR1.49bn and, 2) to fully acquire Wateen Solutions (currently a 51% subsidiary of Wateen Telecom) at PKR490mn.
- Operating performance:** Wateen telecom (on consolidated basis) has seen tremendous growth in sales and net income since start of its operations in FY05. Company's revenues grew at 3-year CAGR of 80% during FY06-FY09 period and EBITDA margins remained stable between 18-22% during the same period. Net margins declined by 700bps YoY to 10% in FY09 primarily due to 177% higher financial charges of PKR568mn. Though Wateen telecom reported only 6% YoY decline in net profit to PKR1,018mn during FY09, it is worthy to note that the company changed its depreciation rates during the year. Had the depreciation rate not been changed, depreciation charges

would have been higher by PKR400mn (EPS impact of PKR1.24 at 208mn shares). Revenues declined by 53% YoY in 1HFY10 primarily due to declining revenues from LDI segment (owing to reduction in APC (Access Promotion Charges) from US\$12.5/minute in Jun-09 to current rate of US\$10/minute and no new 'Indefeasible Right of Use' contract during the half.

▪ **Key risks and concerns:**

- **Leverage, the main risk:** Wateen telecom has aggressively leveraged its balance sheet for expansion plans in recent years. Debt to equity ratio has deteriorated from 77% in FY08 to 437% in 1HFY10. Interest coverage ratio has also declined from 7.2 times in FY08 to -0.8 times in 1HFY10.
- **Uncertain revenue stream on wholesale front:** Revenue stream of Wateen telecom from wholesale segment (managed capacity, dark fiber) is quite volatile owing to its contract based nature. For example, management expects revenues from managed capacity to decline to PKR1.2bn in FY10 from PKR4.6bn in FY09. However in FY11, these revenues are expected to rebound to PKR4.9bn primarily due to USF subsidy and contract to provide services in Afghanistan. This contract based nature of material revenues adds to instability in top line.
- **Aggressive revenue recognition criteria for IRU on dark fibre:** Dark Fiber is leased to organizations seeking dark fiber connectivity on an 'Indefeasible Right of Use' (IRU) which varies from 3 years to 20 years. IRU revenues contributed PKR3.4bn (41% of total revenues) and PKR4.0bn (26% of total revenues) during FY08 and FY09 respectively. Company has a policy of recognizing all the revenues from granting of Indefeasible Right of Use of dark fiber for 20 years in the year of sale. Internationally, revenue recognition policy for Dark Fiber range from aggressive policies like full revenue recognized in the year of sale to prudent policies like recognizing revenues equally over agreement period.
- **Assumed change in WiMAX business model:** Wateen telecom currently holds above 60% market share (+150,000 customers) in Wireless Broadband services owing to its presence in 22 cities with 1,100 sites. Though management expects WiMAX to have net positive impact on bottomline post FY12, they have assumed a change in WiMAX business model during that period. Currently, the Customer Premises Equipment (CPE, the modem provided to customers by Wateen) is owned by Wateen and is depreciated in Wateen's financials. Going forward, management expects the CPE equipment prices to fall down to USD40-50 as compared to price of around USD200-250 at which Wateen bought them during past years. Owing to such fall in CPE equipment prices, management is anticipating change in WiMAX business model where consumer will buy their own equipment from market and will only use Wateen's network. This change in business model will reduce depreciation expense, effectively producing net positive impact on bottom line. In our opinion, such change in business model is quite subjective to future WiMAX market conditions and pose as a risk to bottomline projections. Moreover, management also expects the network costs (major cost component) for WiMAX services to remain flat post FY11 due to change in business model.
- **Aggressive revenues expected from VAS:** Management expects significant revenue growth from Value Added Services (VAS) on back of its WiMAX services. Revenues earned by providing 'Premium Content' to its WiMAX customers, which is currently immaterial in total revenue pie, is expected to pass PKR1.5bn mark by FY12. As per our discussions in industry, 'Premium Content' services have not been quite a success in Pakistan owing to availability of cheaper pirated DVDs and presence of cable operators in the country.
- **Proposed acquisition of Wateen Solutions:** Wateen telecom has proposed to acquire 397mn shares (49% of total share capital) having face value of PKR100 each to make Wateen Solutions a wholly owned subsidiary (currently 51% subsidiary of Wateen telecom). Our concern about the proposed acquisition and its price mainly stems from following point: The prospect 49% shares of Wateen Solutions were sold by Wateen telecom to Mr. Jahangir Ahmad (an ex-employee) during FY09 at a price of PKR131/share and now the same 49% stake is being bought back at PKR1,234/share, 8 times premium to last transaction within 12 months time.

Action and recommendation

- Due to risks like high leverage and volatile revenues streams, we recommend investors to not subscribe to this public offer.

Fig 1: Historical financial performance

Figures in PKRmn	FY07	FY08	FY09	1HFY10
Revenues	4,448	9,289	16,184	4,916
Cost of sales	2,726	5,235	10,947	4,050
EBITDA	785	1,998	3,018	(90)
Depreciation	67	435	960	763
Finance cost	166	205	568	964
PBT	578	1,559	1,681	(1,756)
PAT	385	1,084	1,018	(1,215)
EPS (before 100% bonus in Sep 09)	1.84	5.19	4.88	(5.82)
EPS (post 100% bonus in Sep 09)	0.92	2.60	2.44	(2.91)
Total Equity		3,747	4,767	3,587
Long term Liabilities		1,681	9,450	11,547
Current liabilities		9,392	10,622	11,356
Total Assets		15,550	26,289	27,660
Book Value per share (417mn shares)		8.98	11.42	8.59
Debt/Asset		18%	39%	57%
Debt/Equity		77%	215%	437%
Interest coverage	4.4	7.2	2.1	(0.8)

Source: FS Research, Offering Prospectus