

BUY

SLRs.18.00

Sector: Telecommunication

Date: 01 June 2006

CSE Code: SLTL

Index Level: 2221.45

Key Data:

12m Price Range: SLRs 27-14.70

Market Cap (SLRs.mn/ US\$m):

32487/318.5

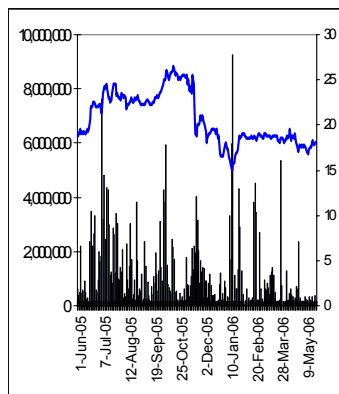
Shares in Issue (m): 1804.86

Book value / shares (SLRs): 19.44

Price / Book value (x): 0.93

Forecasted PE (X): 5.75

Price chart:



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Sri Lanka Telecom

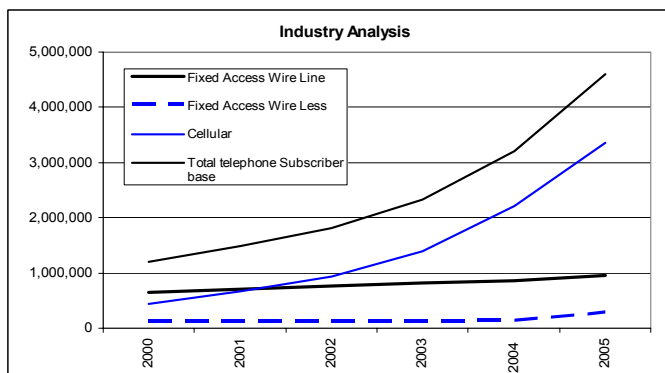
The Communication Powerhouse!

Financials

Year to Dec (SLRs.mn)	FY03A	FY04A	FY05FC	FY06FC	FY07FC	FY08FC
Revenue	25553	29,516	32,515	39,553	47,229	56,011
Revenue Growth (%)	n/a	15.51%	10.16%	21.65%	19.41%	18.59%
EBITDA	14,346	12,645	16,263	20,804	24,675	30,093
PAT	2,249	1,293	3,093	5,648	7,977	11,221
EPS (SLRs.)	1.25	0.72	1.71	3.13	4.42	6.22
EPS growth (%)	n/a	-42.4%	137.5%	83%	41.2%	40.7%
PER (x)	14.65	21.98	10.50	5.75	4.07	2.90

Sri Lanka Telecom (SLT), with a market cap over US\$300mn is one of the top companies on the Colombo Bourse with a substantial foreign demand. Being the market leader of Sri Lanka's fixed telephony market, SLT is a company with a steady income stream expecting rapid growths through its mobile arm, Mobitel which has already captured 19% of the mobile market since acquisition in 2003.

Industry Outlook The telecommunication industry is regarded as one of the fastest growing industries in Sri Lanka, with an average growth rate of 30% to 35% each year. The now fully liberalized industry is poised to thrive as it could be identified by the latest statistics showing 77 licensed operators at the end of 2004 as against 40, two years ago. These companies offer numerous services in line with the latest communication technology and the available services include, fixed access telephones, as both wire and wireless connections, cellular connections, internet and e-mail, pay phones, radio paging etc. The mobile network of the country has been in the forefront of the recent telecommunication boom with 73% of the telecom market being dominated by the mobile operators. The mobile subscribers increased by more than 1.5 times during 2005 reaching 3.36mn while the total telephone subscriber base in the country grew by 44% over 2004.



The growth in the industry had been primarily due to the timely liberalization, which enabled the country to attract a number of international telecommunication giants to invest in the necessary telecom infrastructure. In addition, this assisted the local industry in obtaining latest technology at the same time expanding communication facilities through out the island. GPRS and 3G technology in mobile telephony are two examples for such technology obtained and Sri Lanka was the first country to introduce these to the South Asian region. Some of the companies, which invested in Sri Lanka after the liberalization in 1996, include some well-known names such as, NTT-Japan, Telecom Malaysia, Telstra – Australia, Hutchison Whampoa– Hong Kong and Telia, the national telecom operator of Sweden.

Sri Lanka Profile

Location: Southern Asia, island in the Indian Ocean, south of India

Area: *total:* 65,610 sq km
land: 64,740 sq km
water: 870 sq km

Natural resources: limestone, graphite, mineral sands, gems, phosphates, clay, hydropower

Natural hazards: occasional cyclones and tornadoes

Population: 20,222,240 (July 2006 est.)

Population growth rate: 0.78% (2006 est.)

Literacy: *definition:* age 15 and over can read and write

Total population: 92.3%
male: 94.8%
female: 90% (2003 est.)

GDP (purchasing power parity): \$87.15 billion (2005 est.)

GDP (official exchange rate): \$21.5 billion (2005 est.)

GDP - real growth rate: 5% (2005 est.)

GDP - per capita (PPP): \$4,300 (2005 est.)

GDP - composition by sector:
agriculture: 17.7%
industry: 27.1%
services: 55.2% (2005 est.)

Labor force: 8.08 million (2005 est.)

Inflation rate (consumer prices): 11.2% (2005 est.)

Investment (gross fixed): 27% of GDP (2005 est.)

Public debt: 98.5% of GDP (2005 est.)

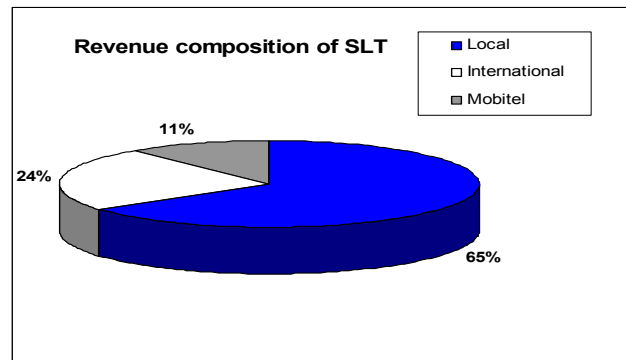
Exchange Rate: SLRs per US\$-100.498 (2005)

The tele-density of the country increased by 4.1% during 2005 as against the previous year and is now standing at 23.4%. The breakdown of this comes as 6.3% in fixed lines and 17% in mobile connections. This is the highest in the South Asian region and is well above the 8% overall density of India and 3% to 4% of Pakistan. The market penetration level in mobile telephony is 5% in India which is again far below the 10% in Sri Lanka. Though this is the case, it should be noted that the tele-density of Sri Lanka is still much lower than the average of the developed countries, which is around 50%. Similarly, it is the same with mobile penetration, in which the world average is around 25% while the average in developed countries hovers around 70%. However it should be accepted that low penetration levels and density on the other hand means more growth opportunities. There is still much potential for telecommunication investments within the country, especially in rural areas. Confirming this fact, through out the past decade Sri Lanka has been a prime choice among many global telecom operators as a comparatively better investment opportunity.

History of the company SLT was the pioneering telecom company in the country, which was then fully owned by the government and was known as ‘Sri Lanka Telecom Corporation’ (SLC). In 1996 the local telecom industry was liberalized ending the monopoly status of SLC. During the same year ‘Sri Lanka Telecom Limited’ was created and in 1997, NTT of Japan invested in a 35% stake of the company’s capital apart from taking over the management. In 2003, licenses were granted to other private telecom operators to handle international call traffic, thus reducing SLT’s international call revenue from 60% to 30% of the total income. However SLT is still considered as the largest telecom company in the country in terms of infrastructure, being the sole provider of fixed cable connections. The company is regarded as the telecom operator with the highest income as well. The growth of the customer base and the revenue stream of SLT was fuelled by its 100% stake in Mobitel, a leading mobile operator.

Valuation SLT is currently trading at a considerable discount which is 50% of its estimated counter price of SLRs.36 based on their closest comparator, Dialog GSM's PE of 11.6x. On a forecasted EPS of 3.13 and an expected market PE of 13x, the fair value of SLT is SLRs40. Based on our Price to Book Value computation we derived a counter price of SLRs.35 per SLT share.

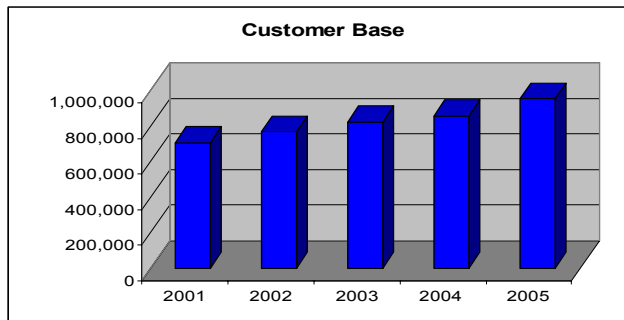
Overall financial Performance SLT consolidated itself as the Number One Sri Lankan Company by yet again showing strong performance in the financial year ended December 2005. Both its local and international call segments recorded revenue growths of 9% as a result of increased customer base during the year and further contribution from data oriented services, value added services and inclusion of new businesses (i.e. telephone directory) enabled the group to record an overall revenue of SLRs.32.5bn, which was a 10% increase over the previous year.



The group having retired some of its high interest rate bearing loans during 2004 reduced its finance cost by 7% negating the increase in operating costs of 7%. This together with the International Operator's Levy reducing by SLRs.924mn compared to a year ago and Interest Income recording a growth of 221% enabled the group to gain a massive 139% increase in net profits to SLRs.3093mn.

The first quarter profit of SLT for the year 2006 was SLRs.1.3bn posting an increase of 42% compared to the previous year. The group was able to achieve this due to a revenue increase of 28% whilst maintaining modest increases in operating costs and depreciation.

Market Performance of SLT The fixed line telephony maintains its position as the highest contributor to SLT's growth. In 2005, SLT captured 93,592 new subscriber lines to retain its position as Market Leader enjoying as high as 77% of the total market. The Customer base as at the end of the year stood at 954,060 lines. It was significant to note that 10,923 of these lines were supplied to the North and East despite rising political upheaval. The tele-density of the country still being at 6.32 telephone lines per 100 persons, will enable the company to penetrate more into this segment possibly maintaining its compound annual growth rate of 7% in its subscriber base.



Source: SLT Annual Report

Predominant Infrastructure and Technology SLT's microwave copper based network is based on a technology that is superior to any other network in the country. But in understanding the future need, this fiber network is being enhanced to a more high-speed island wide optical fiber network to ensure high transport capacity and seamless connectivity region wide.

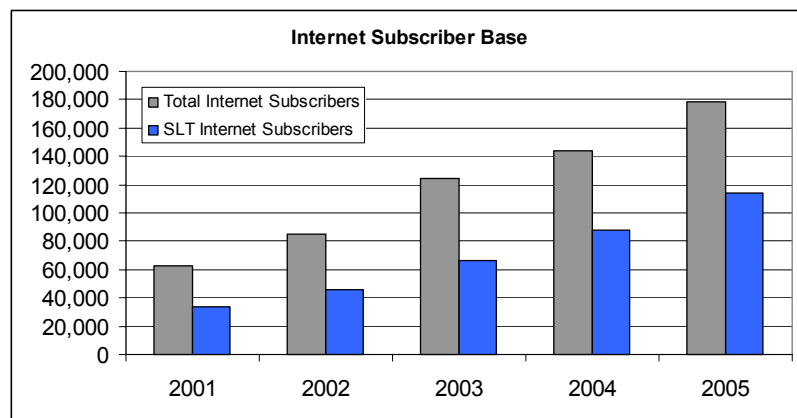
Further, SLT will be introducing IP transport technology which will support the convergence of broadband services such as Next Generation Network (NGN), All-IP CDMA, ADSL, Wi-Fi island-wide and by 2009 include an additional fibre ring, the high speed Optical Fibre Super Highway (STM-64). This will enable SLT to offer a standards-based wireless technology called WiMAX to provide high throughput broadband connections over long distances through the use of the above mentioned microwave links. WiMAX will support voice, high-speed Internet connectivity, email, fax, and data services.

The undersea fiber optic cables SEA-ME-WE 3 and SEA-ME-WE 4 has been able to elevate the group's global connectivity in par with international levels. SEA-ME-WE 4 been built on DWDM technology will enable performance to be at tetrabit per second as well as support connectivity across the East and West, link South East Asia to the sub continent as well as the Middle east and Europe. SLT will be looking at selling excess capacity on this cable to other operators.

The Bharat Lanka cable system, expected to start operating by July 2006, will enable both SLT and Bharat Sanchar Nigam (BSNL), the seventh largest telecommunication operator in the world, to access foreign countries using each others existing and future cable networks such as SEA-ME-WE 3, SEA-ME-WE 4 and the internal terrestrial networks of BSNL. At first, the system will be running at a capacity of 10 gigabits per Second, targeting up to 160 gigabits per seconds to benefit corporate and personal customers of both India and Sri Lanka with Competitive International Private Leased Circuits (IPLCs), broad band internet, direct and transit international direct dialing (IDD) traffic, Internet protocol (IP) backbone networks and multimedia content services.

CDMA technology Code Division Multiple Access (CDMA) technology will aid SLT in their objective of eliminating existing disadvantages to citizens of Sri Lanka in terms of their access to communication. Whilst providing such access to remote locations in the North, East and the Deep South of the island, CDMA connections are of superior quality granting users already in city limits a range of services. Hence, SLT can deploy this technology at a reduced cost and at a faster rate in comparison to connecting via the present wired access technology. Currently servicing a CDMA subscriber base of 120,000 customers, SLT will target to increase its subscriber capacity by 150,000 year on year.

Internet Services SLT's ADSL (Asymmetric Digital Subscriber Line) technology serves more than 13,312 domestic and corporate users island wide enabling them to browse and use telephone lines at the same time for communication purposes. In the overall market of Internet users, SLT again places itself in a dominant position, seizing 64% share.



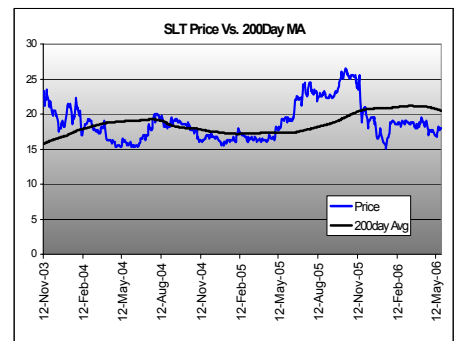
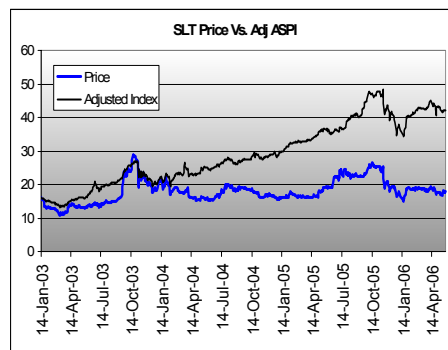
Aggressive Mobile Coverage Mobitel the wholly owned subsidiary of SLT is only second to Dialog, the largest mobile operator in Sri Lanka. Possessing the only network in the island that provides pre-paid roaming, Mobitel boasts of a comprehensive roaming coverage and is continuously looking to expanding coverage and value added services offered to its invaluable and expanding customer base. As at the year-end 2005, its subscriber base had grown by 48% to 420,062 compared to the previous years' 284,430 and thus capturing 19% of the mobile telecommunication market of Sri Lanka. The company's operating profit grew by a massive 382% to SLR.806mn in 2005 reaping benefits from aggressive investments in technology and network expansion. Despite a strong operating performance recorded, the company was only able to relieve its previous year's loss by only 6% registering a year end net loss of SLRs.1.1bn. However it is expected to breakeven by the 2nd Quarter of 2006. The reason for this was the high depreciating costs of heavy investments and interest charges from the company being highly geared.

The company's expansion plans include increasing its subscriber capacity from its current 400,000 to 1,000,000 by the end of this year and adding more than 350 new base stations to provide wider coverage and uninterrupted connectivity.

Way Forward Currently the industry thrives on coverage and players in with expanded networks are reaping benefits from their investments in infrastructure. In the years to come, with rising competitiveness in the industry and the market reaching its saturation we expect the competence to shift towards supplying a more sophisticated customer demanding rich and ready to use latest of technologies. Hence, consumers will demand more choice, flexibility and greater control, urging the telecommunication providers to innovate new products of superior quality and reliability at a faster delivery time.

SLT raising itself to the challenge, will be rolling out a modern IP based platform that will enable SLT's network to evolve into an ultra modern Next Generation Network (NGN) providing multiple services on a single platform. This facility will amalgamate voice, data, and Internet connectivity together with application services to both the local and global markets.

Relative performance



The information contained in this report, researched and compiled for purposes of information do not purport to be complete description of the subject matter referred to herein. In preparing this report care has been exercised to collect information from sources which we believe to be reliable although we do not guarantee the accuracy and completeness thereof. Lanka Securities (Pvt.) Ltd. And/or its affiliates and/or its directors, officers and employees shall not in any way be responsible or liable for loss or damage which any person or party may sustain or incur by relying on the contents of this report and acting directly or in indirectly in any manner whatsoever.

Earnings Model						Growth Rates (%)					
Yr to Dec (SLRsmn)	2004A	2005A	2006F	2007F	2008F	Yr to Dec	2004A	2005A	2006F	2007F	2008F
Total Revenue	29,516	32,515	39,553	47,229	56,011	Domestic revenue growth	10.11%	6.55%	22.00%	18.00%	15.00%
domestic revenue	19,726	21,019	25,643	30,259	34,798	International revenue growth	28.17%	17.43%	21.00%	22.00%	25.00%
Int'l revenue	9,790	11,496	13,910	16,970	21,213	Total Revenue Growth	15.51%	10.16%	21.65%	19.41%	18.59%
Total Operating Expenses	14,485	15,512	17,799	21,725	25,205	Operational Expense Margin	49.08%	47.71%	45.00%	46.00%	45.00%
Operating profit	15,031	17,003	21,754	25,504	30,806	Depreciation	8.63%	4.62%	10.00%	2.00%	4.00%
						Growth in long term debt	54.59%	-8.45%	-5.30%	-5.00%	-8.00%
EBITDA	12,645	16,263	20,804	24,675	30,093	Ratio Analysis					
						Yr to Dec	2004A	2005A	2006F	2007F	2008F
EBIT	3,693	6,897	10,502	14,166	19,164	Liquidity (x)					
Financial charges	2,252	2,085	1,812	1,894	1,901	Current Ratio	1.95	1.72	2.53	2.40	2.25
EBT	1,441	4,812	8,689	12,272	17,263	Solvency (x)					
taxation	148	1719	3041	4295	6042	Long term debt to total assets	0.27	0.23	0.22	0.19	0.16
PAT	1293	3093	5648	7977	11221	Long term debt to equity	0.67	0.55	0.46	0.38	0.29
						Interest cover	1.64	3.31	5.79	7.48	10.08
						Assets to equity	2.54	2.32	2.11	1.96	1.81
Price to Earnings Valuation						Market Measures					
Market price					18.00	EPS (SLRs)	0.72	1.71	3.13	4.42	6.22
EPS (Expected)					3.13	BV (SLRs)	17.21	19.44	21.67	25.01	29.93
Dialog P/E (Expected)					11.60	Price to Book (x)	0.92	0.93	0.83	0.72	0.60
Price based on Sector P/E(SLRs)					36.30	PE(x)	21.98	10.50	5.75	4.07	2.90
						Profitability					
Price to Earnings Valuation						EBITDA margins	42.84%	50.02%	52.60%	52.25%	53.73%
Market price					18.00	EBIT margins	12.51%	21.21%	26.55%	29.99%	34.21%
EPS (Expected)					3.13	Pre-tax margins	4.88%	14.80%	21.97%	25.98%	30.82%
Market P/E (Expected)					13.00	Net Profit Margin	4.38%	9.51%	14.28%	16.89%	20.03%
Price based on Market P/E(SLRs)					40.68	Net Profit Growth	42.51%	139.21%	82.61%	41.23%	40.67%
						ROE	4.16%	8.82%	14.44%	17.67%	20.77%
Price to Book Valuation						ROA	1.64%	3.73%	6.85%	9.02%	11.47%
Market price					18.00						
BVPS (Historical)					19.44						
P/B Ratio					0.93						
Market P/B Ratio (Expected)					1.80						
Price based on Sector P/B(SLRs)					34.99						