

Sri Lanka Telecom (SLTL)

BUY



Sri Lanka

Telecom

SLRs. 18.75

DFCC STOCKBROKERS

“Ringing High”

- Telecom industry's fixed line penetration growth (24.1% in FY05) gradually giving way to its mobile counterpart (50.4% in FY05). However mid FY05 saw a surge for fixed line providers, with the introduction of CDMA technology. Mobile telephony experiencing rapid growth, with penetration expected to grow to 24.0% in FY06F and 3G services entering the industry.
- SLTL's performance in the fixed line arena given a boost with the introduction of CDMA, which it has capitalised with 180% growth in subscribers in 1Q06. Mobitel poised for growth with the expansion of its coverage, introduction of attractive packages and trials on 3G services. SLTL is expected to achieve a forecasted sales growth of 20.5% and a net profit growth of 58.2% in FY06F.
- SLTL is trading at a 69% discount to the fair value of SLRs.60.49, calculated using DCF valuation method. Sector PE valuation estimates a price of SLRs.31.01 in FY06F. Hence we recommend SLTL a **BUY**.

Year to date Dec (SLRs.000')	2005	2006F	2007F
Revenue	32,515,000	39,193,783	43,250,288
YoY % change (1)	10.16%	20.54%	10.35%
EBITDA	17,003,000	21,704,703	24,687,526
YoY % change (1)	13.12%	27.65%	13.74%
Net Profit	3,093,000	4,894,373	7,654,205
YoY % change (1)	139.21%	58.24%	56.39%
EPS (SLRs.)	1.71	2.71	4.24
Earnings Yield	10.39%	14.46%	22.62%
PER (x)	9.63	6.91	4.42
P/ B (x)	0.88	0.87	0.73
ROE	9.15%	12.63%	16.49%
ROCE	14.73%	20.85%	24.44%

(1) YoY % change is between the current and the last year.

Date: 22/08/06

Reuters Code: SLTL.CM

Index Level: 2,120.94

Free Float: 15.31%

12m Price range SLRs:
10.50-30.00

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Sri Lanka Telecom

Key Data

Share Price Range (SLRs.)	10.50 -30.00	Estimated free float (%)	15.31%
Market Capitalisation (SLRs. mn)	33,842	Shares in issue (mn)	1,805

Key Ratios

Yr to Dec	2005	2006F	2007F
EPS (SLRs.)	1.71	2.71	4.24
EPS 4 Year CAGR	10.12%	16.20%	35.82%
Earnings yield	10.39%	14.46%	22.62%
EPS Growth	139.21%	58.24%	56.39%
PER (x)	9.63	6.91	4.42
PEG (x)	95.10	42.69	12.34
G-PE	1.05%	2.34%	8.10%
BVPS (SLRs.)	18.72	21.48	25.72
P/B (x)	0.88	0.87	0.73

Profitability

Yr to Dec	2005	2006F	2007F
Sales growth	10.16%	20.54%	10.35%
Sales 4 year CAGR	10.18%	11.47%	14.06%
EBITDA growth	13.12%	27.65%	13.74%
EBITDA 4 year CAGR	6.57%	8.68%	13.98%
EBITDA margin	52.29%	55.38%	57.08%
NP growth	139.21%	58.24%	56.39%
NP Margin	9.51%	12.49%	17.70%
Asset Turnover	39.89%	46.14%	47.61%
ROE	9.15%	12.63%	16.49%
ROA	7.67%	5.76%	8.43%
ROCE	14.73%	20.85%	24.44%

Key Forecasts - Yr to Dec SLRs. 000's

Income Statement	2005	2006F	2007F
Revenue	32,515,000	39,193,783	43,250,288
EBITDA	17,003,000	21,704,703	24,687,526
Operating Profit	7,637,000	11,804,543	14,859,392
PBT	4,812,000	8,340,143	11,480,733
Tax	(1,719,000)	(3,445,770)	(3,826,528)
Net Profit	3,093,000	4,894,373	7,654,205

Solvency

Yr to Dec	2005	2006F	2007F
Total Liabilities to Total Assets	58.55%	54.36%	48.91%
Total Debt to Total Debt + Equity	40.33%	33.36%	26.62%
Total Liabilities to Equity	118.90%	101.59%	82.88%
Long term debt to equity	77.79%	64.76%	51.77%
Net debt to equity	24.77%	12.06%	-10.95%
Assets Equity	241.23%	219.12%	195.72%
Asset growth	3.36%	4.19%	6.96%
Liability growth	-0.88%	-1.99%	-2.30%

Balance Sheet

	2005	2006F	2007F
Total Assets	81,520,000	84,939,176	90,847,865
Total Liabilities	40,181,000	39,379,442	38,472,096
Shareholders' Funds	41,339,000	45,559,734	52,375,769

Cash flow

	2005	2006F	2007F
Net cash from operating activities	17,200,000	15,159,653	17,204,845
Net cash from investing activities	(10,686,000)	(11,461,326)	(7,450,000)
Net cash from financing activities	(2,571,000)	(3,436,000)	(2,563,302)
Increase/decrease in cash	3,943,000	262,327	7,191,543

Liquidity

Yr to Dec	2005	2006F	2007F
Current Ratio	1.72	1.82	2.38
Quick Ratio	1.66	1.75	2.30
Cash Ratio	1.04	1.03	1.52
Receivables Turnover	3.81	3.81	3.81

Interim Results - SLRs. 000's

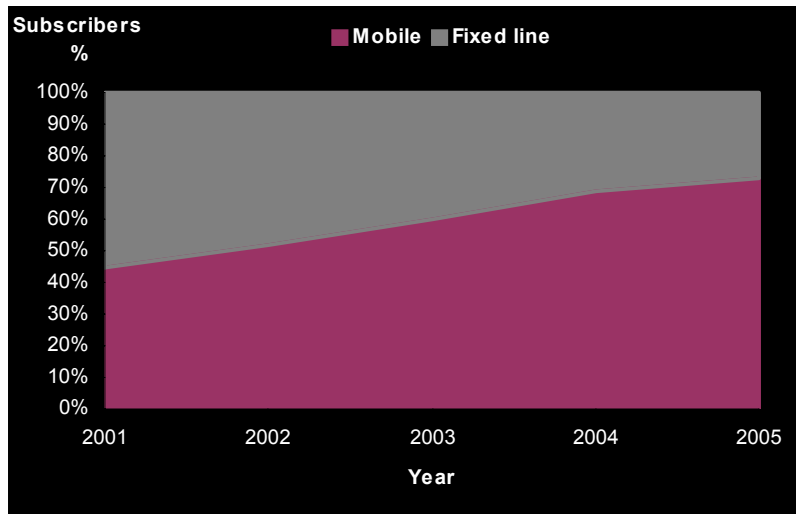
Three Months to March	Q2 05	Q2 06	QoQ %
Revenue	7,624,000	9,966,000	30.72%
EBITDA	4,045,000	5,724,000	41.51%
Operating profit	1,639,000	3,290,000	100.73%
Net Profit	471,000	1,000,000	112.31%
Fixed Assets	56,111,000	56,069,000	-0.07%
Current Assets	21,448,000	26,938,000	25.60%
Shareholders' Funds	31,956,000	34,816,000	8.95%
Non-current Liabilities	33,752,000	31,444,000	-6.84%
Current Liabilities	11,851,000	16,747,000	41.31%

General Facts

Yr to Dec	2003	2004	2005
Mobitel subscribers (000')	112	284	420
SLT subscribers (000')	823	860	954
SLT subscriber growth (%)	7.07%	4.55%	10.88%
SL Mobile Penetration (%)	7.24%	11.37%	17.09%
Mobitel Mobile Penetration (%)	0.58%	1.46%	2.14%
SL Fixed Penetration (%)	4.88%	5.10%	6.32%
SLT Fixed Penetration (%)	4.27%	4.42%	4.85%
SLT WL market share (%)	87.64%	86.81%	76.69%
SLT Total market share (%)	70.57%	53.74%	29.83%

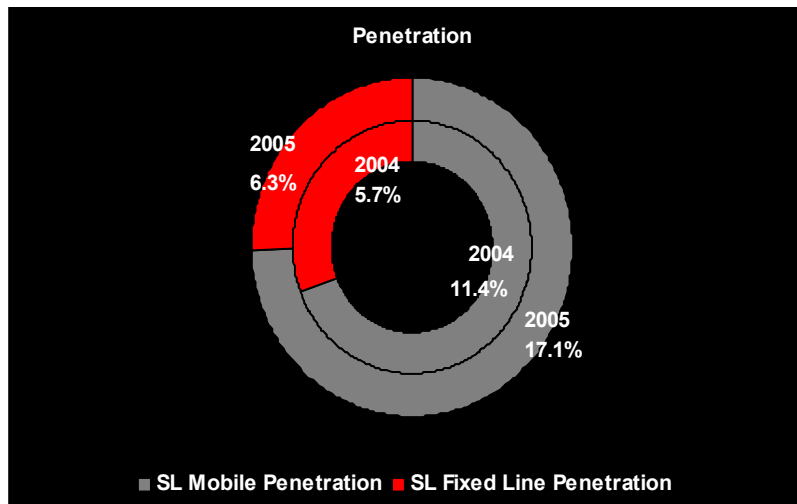
Telecom industry following the broad trend of developed telecom markets, with fixed line penetration growth (24.1% in FY05) gradually giving way to its mobile counterpart (50.4% in FY05). However mid FY05 saw a surge for fixed line providers, with the introduction of CDMA technology exclusively to the fixed line market.

Telecom industries in mature markets experience a decline in fixed line penetration growth, while mobile telephony takes over the expansion of the industry. This is been gradually experienced in the Sri Lankan industry, with an exception being made in FY05 and FY06F, with the introduction of CDMA technology exclusively to the fixed line market. This can be seen in the graph depicted below, where fixed line market share was 27% in FY05 compared to 73% of its mobile counterpart within the same period.



Source: TRC

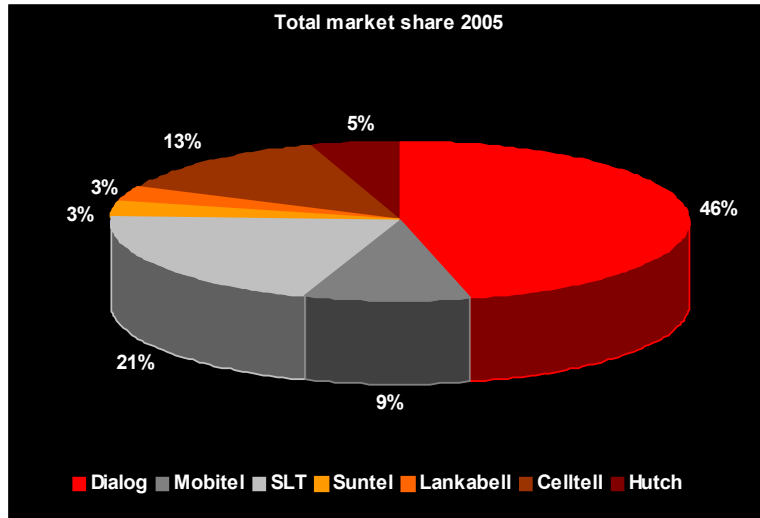
Consequently fixed lines grew 24.1% YoY with its penetration reaching 6.3% in FY05. This trend is expected to continue, with fixed line penetration anticipated to reach 7.7 % in FY06F.



Source: TRC

Mobile telephony in the country experiencing rapid growth, with penetration expected to grow to 24% in FY06F and 3G services entering the industry.

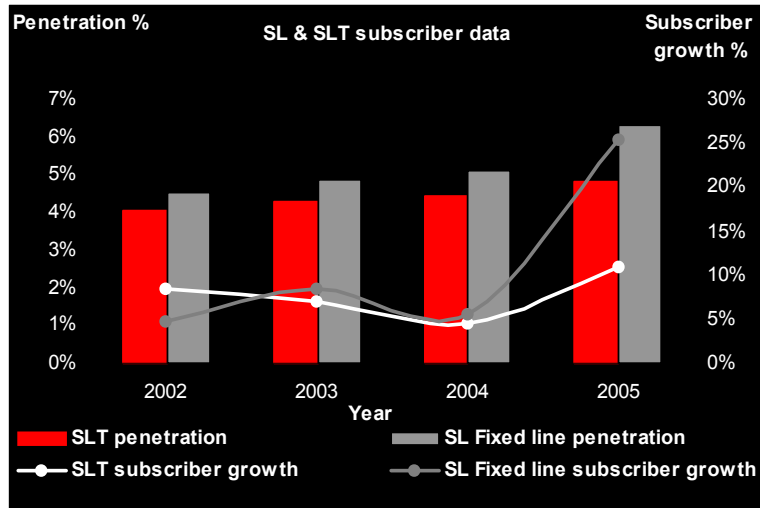
Sri Lankan mobile penetration is expected to reach 24% in FY06F, which is a growth of 40.4% YoY from the 17.1% penetration figure recorded in FY05. Although existing mobile operators are better poised to take advantage of the expanding market, the entrance of the fifth player into the Sri Lankan mobile arena in 3Q06F, ensures stiffer competition for the future. This will also affect prevalent market share of the existing players in the industry, which had DIAL leading the overall market with a 46% market share as at FY05. Third in line was Mobitel with a market share of 9% for the same period (overall market share was 30% in FY05 inclusive of SLTL.)



Source: Company Annual Reports, DFCC Stockbrokers

Leadership in this market will depend on which contributor is better equipped to respond to the future demands of its consumers, in which integrated services are key.

Integrated services seem to be key in the future of the telecom sector, with more and more companies opting for a total solutions provider, who can provide all services. SLTL is well positioned to supply for this market, since it's the only fixed and mobile telecom provider in Sri Lanka at present. Hence SLTL's penetration of 4.9% in FY05, has the potential to be increased in the future.



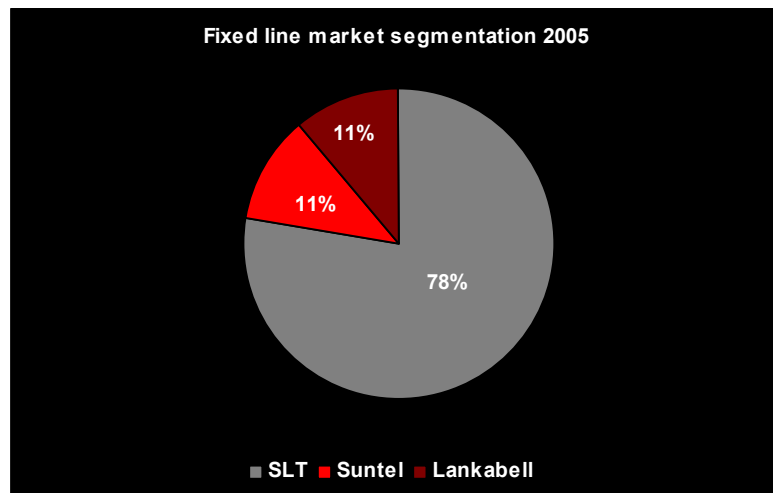
Source: TRC, SLTL Annual Report

SLTL's performance in the fixed line arena given a boost with the introduction of CDMA. Although a comparatively late entry into the CDMA market, SLTL has capitalised on its superior quality services, greater coverage, brand name and outreach into the rural sector, all which contributed to the 180% growth in subscribers within 1Q06. The introduction of new technology in the form of the Next Generation Network (NGN) into the fixed line segment, is set to enhance SLTL's overall performance, and help retain its dominance in this market.

SLTL's performance in the fixed line segment was given a boost with the introduction of CDMA in FY05. Although a comparatively late entry into the CDMA market, subsequent to Lanka Bell and Suntel, SLTL has capitalised this segment on its superior quality services, greater coverage, brand name, and outreach into the rural sector.

SLTL plans to invest SLRs.4bn in FY06F to further the expansion of its CDMA network, which will in turn bring its CDMA base stations up to 200. Synergising with Mobitel in the context of CAPEX requirements for CDMA, (Base stations etc.) has left SLTL with a more cost effective expansion programme as compared with other CDMA operators in the market. This will in turn improve coverage and the quality of services offered by the company. SLTL's massive growth of 180% in CDMA subscribers experienced in 1Q06 and where absolute subscribers increase by 118,751 during 1H06, is due to its sales extending to the rural sector, where SLTL's brand name comes foremost before other competitors.

SLTL's fixed line services are in the process of revamping their switches with Next Generation Network (NGN), which is single IP based network that can provide a diverse number of services from the same platform. Though this process is done in stages, as and when the existing switches need replacement, the advantage of having the best technology at hand will improve the efficiency of SLTL's fixed line network. Overall these measures will enable SLTL to keep its position in the market as the leading fixed line operator.



Source: Company Annual Reports, DFCC Stockbrokers

Mobitel poised for growth with the expansion of its coverage, providence of better quality services and the introduction of attractive packages aimed at diverse spectrum of the market. With the advancement of 3G services, Mobitel is well positioned to operate in the cellular market of the future.

Mobitel is poised for growth in the cellular industry, with a SLRs.3bn planned CAPEX outlay to be utilised for its coverage expansion of 675 base stations in FY06F. Thus Mobitel has the capability to provide its customers with a superior quality service. Mobitel experienced a 48% growth in subscriber figures during FY05, which will continue to be facilitated by the introduction of attractive packages aimed at both the post and pre paid market segments, followed up by heavy advertising in light of the competition existing in the Sri Lankan Mobile telephony sector.

Mobitel's bottom line which recorded a SLRs.1.3bn loss in FY05 was negatively effected by the depreciation of the company's previous TDMA network. This net loss is expected to turnaround in FY06F, with the conclusion of this cost and the full changeover of the company to the GSM network.

Further with licensing and trials undertaken for the new 3G network, Mobitel is well positioned to face the future cellular market.

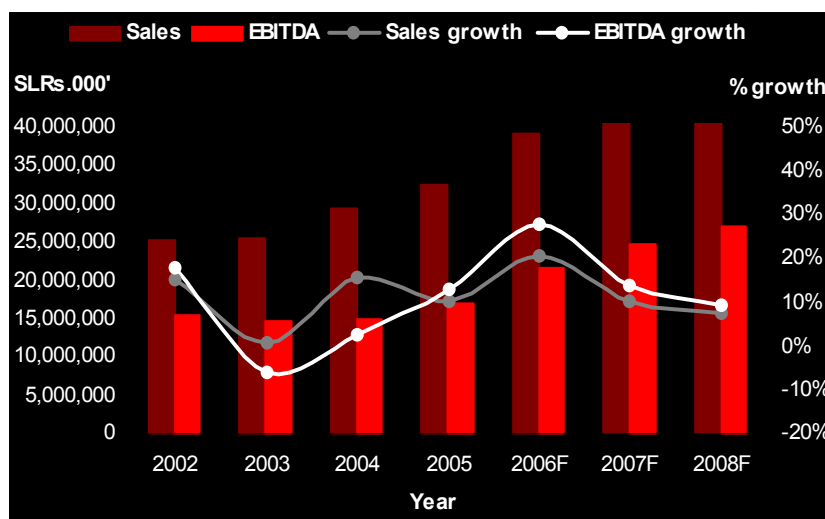
SLTL's other operations which include Internet, Broadband services and International gateway operations are been repositioned, while the future prospects of these services are been enhanced by investments in innovative new technology.

SLTL's Broadband services still remains the sole provider of ADSL services in Sri Lanka and today is concentrating its efforts on bringing its domestic ADSL consumer a better value for money service, via packages that are best suited for this segment. Additionally SLTL has made a massive investment in their fibre optic cable, which has been expanded towards Hambanthota, so that Broadband coverage can be provided to a greater percentage of the country. Wimax technology which will be introduced shortly, which will enable the company to fill in the gaps, where Broadband coverage cannot reach.

SLTL's agreement with BSNL India, which sees the SLTL-BSNL cable been drawn between the two countries, carries potential for high speed data and voice transmission and high proportion of Indian international caller termination to be done through SLTL. This in addition to the SEA-ME-WE-4 line operations and the submarine cable line implementation agreement with Maldives Dhiraagu, will provide SLTL with larger share of international caller revenue in time to come.

Collectively SLTL is expected to achieve a forecasted sales growth of 20.5% in FY06F and sales CAGR of 11.5% for the 4 years from FY02-06F. EBITDA is expected to grow 27.7% YoY and net profit is expected to record a growth of 58.2% in FY06F.

Collectively SLTL is expected to achieve a forecasted sales growth of 20.5% in FY06F and slow down thereafter to 10.4% in FY07F, with the gradual reduction of CDMA growth. Sales CAGR for the 4 years of FY02-06F is expected to be 11.5%. EBITDA is expected to grow 27.7% YoY to reach SLRs.22bn in FY06F. Net profit is expected to record a growth of 58.2% in FY06F, and 56.4% in FY07F.



Source: SLTL Annual Report, DFCC Stockbrokers forecasts

SLTL is trading at a 69% discount to the fair value of SLRs. 60.49, calculated using DCF valuation method. Since telecom companies generate heavy cash flow, we believe DCF valuation is the most suited for valuing SLTL. Sector PE valuation estimates a price of SLRs.31.01 in FY06F for SLTL, giving a 65% upside compared to its current trading levels. We recommend SLTL a BUY according to these valuation methods, as it is clearly undervalued.

DCF Valuation

SLTL has been valued using the DCF valuation method, which is most appropriate for valuing cash rich telecom companies, whose reinvestment is mainly in CAPEX expansions. A WACC of 17% was used to discount free cash flow from FY06-08F, where terminal cashflow growth rate was forecasted to be 3%. With a fair price of SLRs.60.49 and a discount of 69% at current trading levels, we recommend SLTL as a BUY.

Date of Valuation	22-Aug-06		
	2006F	2007F	2008F
Free cash flow	7,296,579	14,133,420	17,092,055
Net interest income	(1,080,898)	(894,732)	(318,536)
Adjusted free cash flow	6,215,681	13,238,688	16,773,519
Period	31-Dec-06	31-Dec-07	31-Dec-08
DF	0.95	0.81	0.70
PV of adj. free cash flow	5,884,142	10,757,492	11,694,461
DCF Valuation	2006F		
WACC (%)	17%		
Cash flow growth rate (%)	3%		
Future Value of TV	127,969,533		
Present Value of TV	89,220,080		
DCF Enterprise value	117,556,176		
Net Debt in 2005	8,372,000		
DCF equity value	109,184,176		
No. of basic shares (000')	1,804,900		
Basic DCF target price	60.49		

Sensitivity of SLTL's fair value of SLRs.60.49, to varied WACC and terminal cash flow growth rates are shown below.

Sensitivity Table						
WACC						
	60.49	15%	16%	17%	18%	19%
Terminal cash flow growth rate	2.0%	66.57	61.23	56.64	52.64	49.12
	2.5%	69.14	63.41	58.50	54.24	50.52
	3.0%	71.94	65.76	60.49	55.96	52.01
	3.5%	75.00	68.30	62.64	57.79	53.59
	4.0%	78.34	71.07	64.97	59.77	55.29

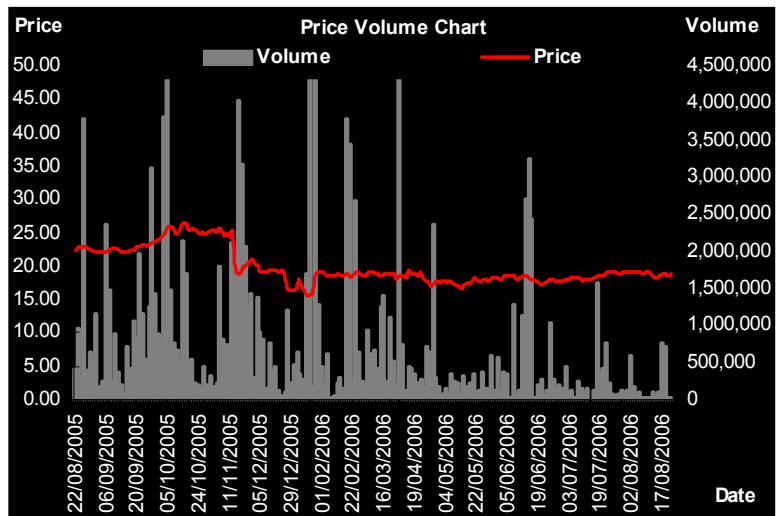
PE Valuation

Sector PE valuation is used to gauge SLTL’s fair price in line with the telecom industry. This valuation gives an expected target price of SLRs.31.01 for FY06F, which translates to a 65% upside. Sector PE was 11.44x at the end of FY05 and EPS for FY06F is expected to be SLRs.2.71. Hence we recommend SLTL a **BUY** according to this valuation method.

Price to Earnings Valuation

	2006F
Market price	18.75
EPS (Historical) FY05	1.71
Historical P/E FY05	9.63
EPS (Expected) FY06	2.71
P/E (Expected) FY06	6.91
Sector P/E (Historical)	11.44
Price based on expected earnings	31.01

Price Volume Chart





Sales

Research

Ray Abeywardena
Prashan Fernando
Naren Godamunne
Reshan Kurukulasuriya
Roy Anthony
Roshan Noah
Susil Fernando
Kala Piramanayagam
Navin Dullewe
Jaliya Wijeratne
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