A New Behemoth in the Indian Telecom Industry: Vodafone India to Merge with Idea Cellular

Vodafone Group Plc (VOD:NASDAQ) - market cap as of 31/03/2017: £55.39bn ($69.48bn)
Idea Cellular Ltd (IDEA:NSE) - market cap as of 31/03/2017: INR 309.51bn ($4.78bn)

Introduction

Vodafone Group PLC, a global provider of telecommunication services, and Idea Cellular Ltd, an Indian telecommunication company, announced their intention to join forces to further pursue growth in the competitive Indian market. The two companies will merge their Indian units creating an entity with a combined $23.2bn enterprise value. The new entity will be jointly and equitably controlled by Vodafone and Idea.
The deal, aimed at creating a leader in terms of number of customers within the Indian markets, represents Vodafone's latest attempt to resume to profits in the world's second largest mobile-phone market.

About Vodafone

Founded in 1985 and based in London, Vodafone is one of the world leading telecommunications companies with a market capitalization amounting to approximately $70bn. Its shares are traded on the London Stock Exchange and NASDAQ. The company operates in 26 countries and has partnership agreements in additional 49, spreading among all the 5 continents.

Vodafone provides a wide range of services ranging from voice, messaging, data and fixed communications to video content, cloud & hosting and Internet of Things offerings. The business is mainly organized in two broad geographic areas: Europe and "AMAP" (Africa, Middle East and Asia Pacific) which account for, respectively, 66% and 32% of total revenues.

Vodafone India represents a significant portion of the "AMAP" business. The company which provides its services to almost 200 million subscribers confirmed its intention to further invest in the Indian market where it has recently launched Project Spring: a long-term plan aimed at covering 90% of the population with 4G services.

In FY2016 Vodafone reported £41.0bn in revenues, a 3% decline YoY. EBITDA was similarly down 2.5% YoY to £11.6bn. Vodafone is experiencing a slowdown in revenue growth in India following the launch of a fierce price war by competitors. Nevertheless, its Indian unit reported revenues of $6.7bn and an EBITDA of $2bn in FY2016.

About Idea Cellular

Idea Cellular is the third Indian mobile network operator by subscriber base, offering to its clients 2G, 3G and 4G mobile services. Headquartered in Mumbai, Idea Cellular's shares trade in the National India Stock Exchange.

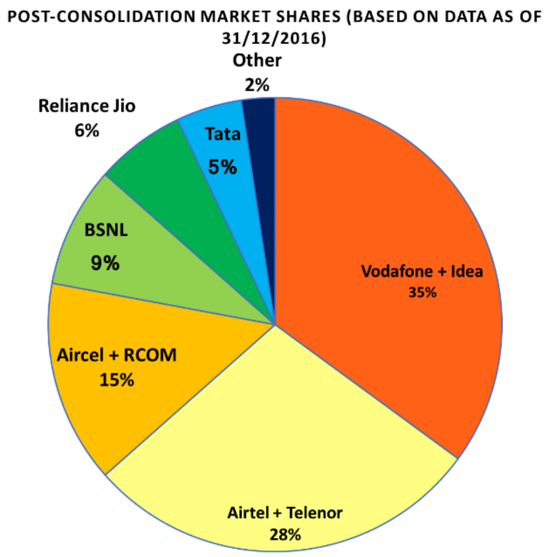
At its inception (1985), AT&T wireless, Aditya Birla Group and Tata Group each held 1/3 of the company. Nowadays Idea is controlled by Aditya Birla Group, the only surviving original shareholder and one of the largest conglomerates of the country. Kumar Mangalam Birla, chairman of Aditya Birla Group and renowned Indian businessman, exercises significant influence over the operations of Idea Cellular.

The company is in good financial shape with annual revenues amounting to $5.5bn and EBITDA of $1.7bn, which represent a YoY growth of respectively 14% and 18% (FY2016). The company in a media release of February 2017 has warned that the increased competitive pressure in the Indian telecommunications market may significantly impact Idea's growth path and margins.

Industry overview

The tale of the Indian wireless market is the tale of a disruptive new-entrant - Reliance Jio - which, by setting off a price war, sent incumbents scrambling for ways to defend their margins and market share. After buying a large swath of licenses in 2010, the company, backed by Indian billionaire Mukesh Ambani, entered the wireless market by launching a nationwide 4G service in September of 2016. By the end of February 2017, it had added 100 million subscribers, gaining over 6% of the market share, thanks to a cut-throat pricing scheme based on free calls and cheap data plans.

Incumbents' response consisted in a wave of consolidations. As of March 2017, the three largest wireless carriers by subscribers were all the result of recently completed tie-ups between previous incumbents. As a consequence, in terms of subscribers, over 90% of India's wireless market is controlled by five companies.



Graph based on data from TRAI

The broad wireless market in India has been subject to a significant transition in recent years. Smartphone adoption has been increasing at a steady clip, with penetration set to grow from 21% in 2014 to 39% in 2019. Increased smartphone usage has been partly driven by falling handset prices and demand for services like mobile banking. The result has been a surge in data consumption. Whether carriers will be able to profit from the booming demand for data will hinge on their ability to put an end to a price war.

Deal structure

As the spirit on the first day was addressed toward an equal partnership, the deal has been structured to secure that both the telecom giants have an equal influence on the new joint company.

According to the terms of the deal, the agreed merger ratio implies an enterprise value for Vodafone India of INR828bn (US$12.4bn) and an enterprise value for Idea's mobile business of INR722 billion (US$10.8 billion), excluding its 11.15% stake in Indus.
Idea will contribute to the partnership all its assets including both all its standalone towers and its 11.5% participation in Indus, whereas Vodafone will contribute Vodafone India, including its standalone towers as well, but excluding its 42% stake in Indus Towers. What remains to be defined is Vodafone's contribution to net debt that will be dependent on Idea's net debt at completion as well as customary closing adjustments.

At the completion of the deal which is expected to be closed by late 2018, the joint company will be owned 45.1% by Vodafone and 26.0% by Aditya Birla Group, whereas, Idea's other stakeholders will own the remaining 28.9%.
To ensure the shareholdings' equality over time, the Aditya Birla Group has a three-year period in which it can exercise the right to acquire up to a 9.5% additional stake from Vodafone under an agreed mechanism. However, if the Aditya Birla Group does not equalize its stake, from the beginning of the fifth year after completion Vodafone should start to reduce its holding in order to equalize its ownership with that of the Aditya Birla Group. Until equalization is achieved, the additional shares held by Vodafone will be restricted and votes will be exercised jointly under the terms of a shareholders' agreement.

Following the completion of the deal, the combined entity will comprise a board of 12 directors, including three directors appointed by each part, and 6 independent directors. Mr. Birla will be the Chairman of the new company, whereas Vodafone will have the right to appoint the CFO. Finally, both the partners will jointly agree on the appointment of the Chief Executive Officer and the Chief Operating Officer.

Deal Rationale

There are two key benefits stemming from this merger.

First, given its horizontal nature, synergies will be quite significant. The companies expect the net present value of run-rates costs and capex synergies to be approximately $10.5bn, after integration costs. The merged company will have higher wireless spectrum availability, which, together with a reduction in overlapping equipment will result in a decrease in capex. Also, a rationalization of network infrastructure, coupled with an optimization of general and administrative costs, will help reduce expenses. The merged spectrum portfolio will also provide the new company with the network capacity required to better compete in a market where data usage has increased 50% year-on-year in 2015.

The second benefit concerns the increase in market concentration that will follow the completion of the merger. A reduction in the number of players along with a more effective ability to compete should provide the new company with some relief from the bitter price war initiated by Reliance Jio.

The deal will enable Vodafone to shed $8bn off its balance sheet and find a suitable alternative to grim prospects of an IPO of its Indian unit. Thanks to it, the British telecommunication giant will be able to put an end to a year marred by a $5.4bn write-down of the unit, which followed the announcement of an additional $7.3bn in investment in the country. The merger is also expected to be accretive of Vodafone's cash flow starting from the first full year of completion.

Still, the transaction values Vodafone India at 6.4x EV/LTM EBITDA, about the same as Idea's multiple of 6.3x EV/LTM EBITDA even though Vodafone's EBITDA have been decreasing more slowly. Also, even though the company is contributing a bigger share of the merged company - $12.4bn in enterprise value versus $10.8bn from Idea, it will only own a 45.1 percent stake, subject to Aditya Birla Group's option to further increase its stake.

Overall, while the deal appears to be providing Vodafone with a good solution to its troubled Indian strategy, it also seems to carry a hefty price tag for the company.

Market reaction

The market reaction following the announcement (which was made on January 27th) was positive, especially for the Indian company. Indeed, during the following days, Idea Cellular saw its stocks going up by almost 38%, while Vodafone's share price rose less by c. 2%.

Since the announcement, Vodafone has been increasing by 7.39%, while Idea Cellular's share prices, after a knee-jerk euphoric period, have been registering a correction phase due to the release of the details of the deal. Nevertheless, Idea's stock prices are still 11.5% higher than pre-announcement levels.

Advisors

Morgan Stanley and Robey Warshaw acted as lead financial advisors for Vodafone while Bank of America Merrill Lynch, Kotak Investment Bank, Rothschild and UBS acted as financial advisors. Idea Cellular was advised by Goldman Sachs.