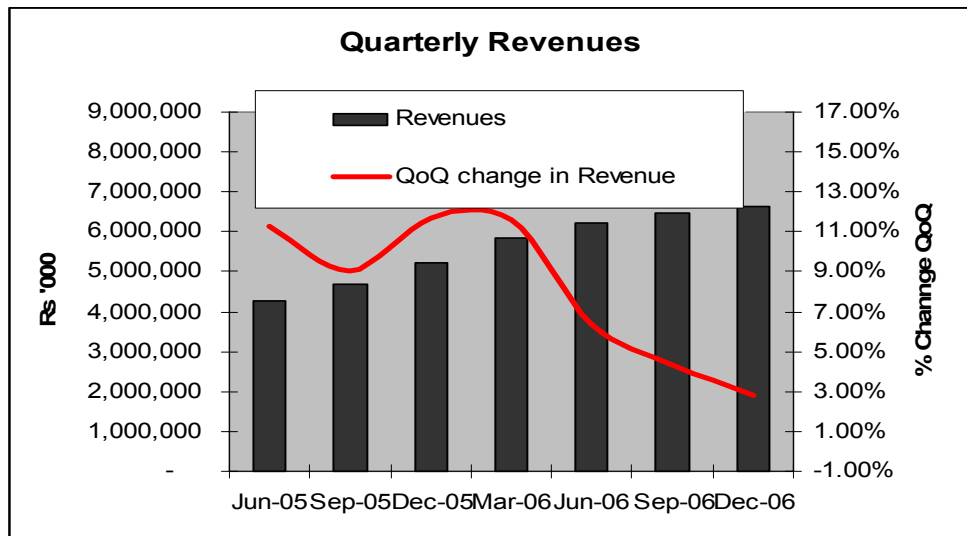


<b>Investment Thesis Summary</b>	<b>Dialog Telekom Limited (DIAL)</b>	<b>Strongly Underweight</b>
	<b>Needing to lead in all new businesses to justify it's valuation.</b>	<b>20<sup>th</sup> February</b>

<p><b>Strategic View</b> <b>Strongly Underweight</b></p> <p><b>Analyst</b> <b>Amal Sanderatne</b></p> <p><b>Share Price</b> <b>Rs28.00</b></p> <p><b>ASPI</b> <b>3004.23</b></p> <p><b>MPI</b> <b>4177.01</b></p> <p><b>Market Cap</b> <b>Rs207,296,184,320</b></p>	<ul style="list-style-type: none"> <li>• With the counter having more than doubled in price post IPO we believe Dialog's stock price now fully reflects the remaining growth that will be seen with as a result of rising mobile penetration in Sri Lanka.</li> <li>• Just released full year numbers for 2006, and a specific analysis of quarterly trends in Dialog's financials offer a early glimpse of the growth challenges that will be faced by the core mobile business of Dialog in the coming years with revenue and profit growth already slowing down on a quarterly basis</li> <li>• Compared to the past when very low interest rates significantly pushed up valuations of growth companies like Dialog, in the new economic scenario of higher interest rates there is a strong negative effect on the fundamental valuation of a growth company such as Dialog.</li> <li>• At a broad level a continued investment in Dialog is very dependent on whether an investor believes Dialog will repeat its success in these new markets.</li> <li>• Dialog has the management capability to replicate such its success in mobile, but we believe specific visibility of successful execution is limited. Till such visibility on these is clearer we believe investors should take a strongly underweight position.</li> </ul>
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## **Investment Summary**

### **In search of the next leg of supernormal growth**

With the counter having more than doubled in price post IPO we believe Dialog's stock price now fully reflects the remaining growth that will be seen with as a result of rising mobile penetration in Sri Lanka. Just released full year numbers for 2006, and a specific analysis of quarterly trends in Dialog's financials offer an early glimpse of the growth challenges that will be faced by the core mobile business of Dialog in the coming years.

In our opinion, the key to a continued positive performance by Dialog in the longer term will be the returns it makes on investments in its next generation network technologies and its push to generate revenues from 3G, data, fixed line and media markets. However we believe the core mobile business will at least for the next two years dominate Dialog's revenues. Immediate visibility on revenues from new businesses is limited in our view. As a result we feel that Dialog will significantly under-perform the broader market in the next two years and as such we believe that Dialog should be at a significantly underweight position within a Sri Lanka portfolio.

Our report is a preliminary overview of some aspects of the fourth quarter numbers released for Dialog Telekom and a detailed discussion of the strategic issues going forward. A comprehensive view with updated forecasts and valuations of the counter will be available following a full analysis of specific drivers for result for 2006 which are expected to be released with the annual report, and following the analysts presentation for the fourth quarter.

### **Fourth quarter financial numbers for Dialog Telecom.**

As this report is a focussed look at the core issues for the mobile business of Dialog, the underneath discussion and analysis of numbers is largely for Dialog Telekom alone and focussed on its' mobile operations rather than on a consolidated basis.

### **Subscriber growth rate to slow.**

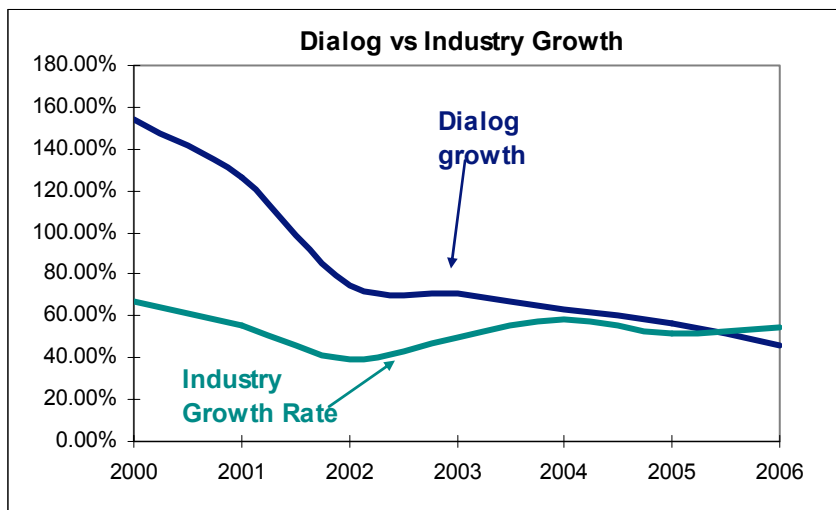
Following the supernormal growth seen in the last few years, we believe that Dialog Telekom is poised to see a relatively lower level of growth in percentage terms in the next two years. The company believes that mobile penetration in Sri Lanka will reach a level of 43% by end 2008 which somewhat ahead of our own projections of a 38% mobile penetration rate in 2008. The market size projections for Dialog's which were disclosed at the CSE road show in Singapore in November 2006, appear to be based on a GDP



growth assumption of 8.1% in 2007 and 2008 while our numbers are based on a GDP growth projection of around 6% in 2007 and 2008.

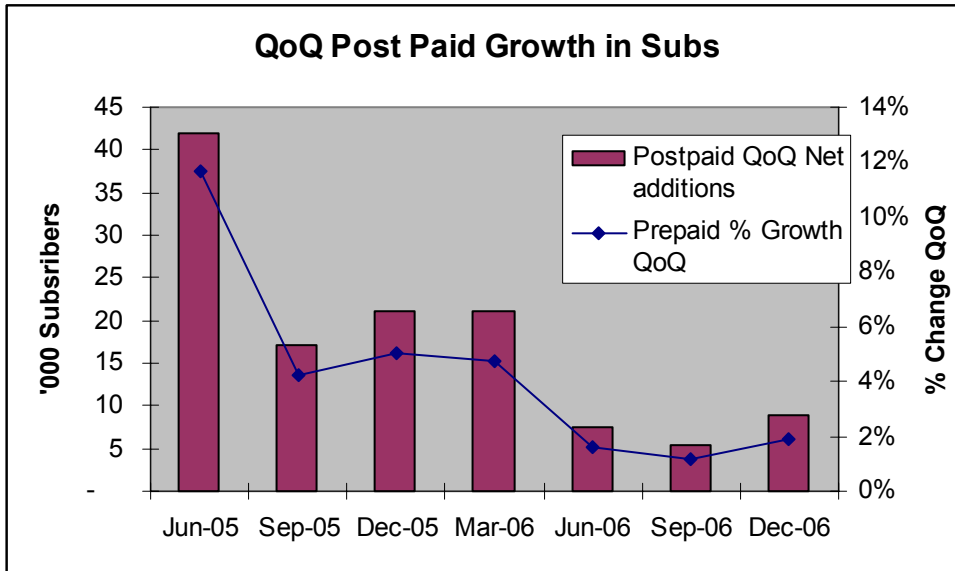
Given that as at 2006 Mobile penetration is was expected to have hit around 26%, even with a 43% projection of mobile penetration as at end 2008, percentage growth in total mobile subscribers in 2007 and 2008 would be around 32% each year compared to growth rates of close to 50% in the recent years. However though the percentage growth is slower, the numbers of subscribers being added to the network could be similar to the past.

If Dialog maintains its markets share, growth in Dialog subscriber numbers would also tend to be in line with market growth. However after many years 2006 appears to have seen Dialog loose market share with the company now estimating a 60% market share compared an estimate of closer to 62% at the end of last year. This is a trend which if continued would see subscriber growth in percentage terms come in lower than even our own projections which are based on Dialog maintaining it's current market share. Going forward we have used the static market share assumption to reflect our confidence in Dialog's management capability. However potential market share erosion going forward is a possible risk factor investors need to keep in mind in the context of Bharti entering the market and Dialogs other competitors also building up their network reach and capacity.

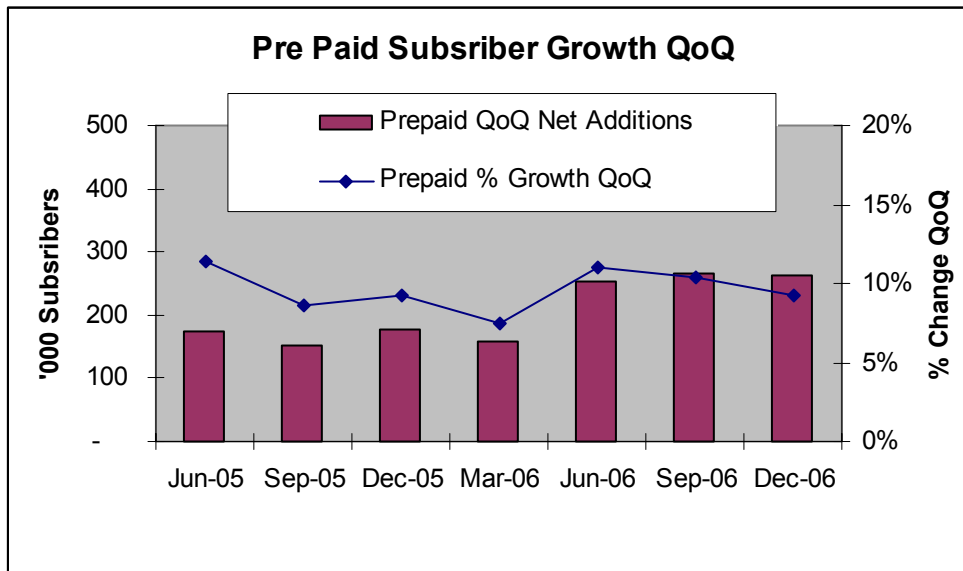


Source: Dialog Telekom, TRC, Internal Estimates.

The issues for Subscriber growth is clearly seen in the underneath depiction of quarterly trends for Dialog Subscriber numbers where recent growth in percentage terms in clearly slowing down. While post paid growth has sharply slowed down to the range of 2% QoQ, Pre paid growth is still strong but appears poised to stagnate or and fall somewhat from the around 10% QoQ levels it has been in recent quarters.



Source: Dialog Telekom.



Source: Dialog Telekom.

### **New Technology prompting usage of value added services pushing ARPU**

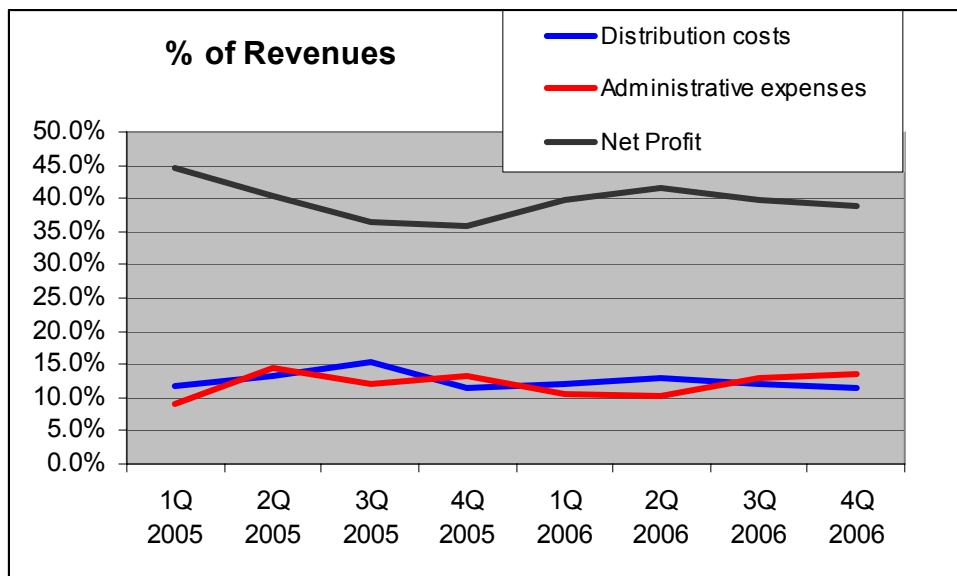
Dialog has in recent times introduced technologies that prompt the use value added services, including entertainment and information offerings. Increased usage of these among customers that have been introduced have contributed to ARPU's not falling sharply as has been the experience in other markets. Given our very positive view on Dialog management capability particular on the marketing and technology side, we are relatively optimistic on the possible maintenance and growth in ARPU's among the existing client base even if the company continues in a pricing strategy of tariffs to customers.

**But higher usage is driving up capex and opex**

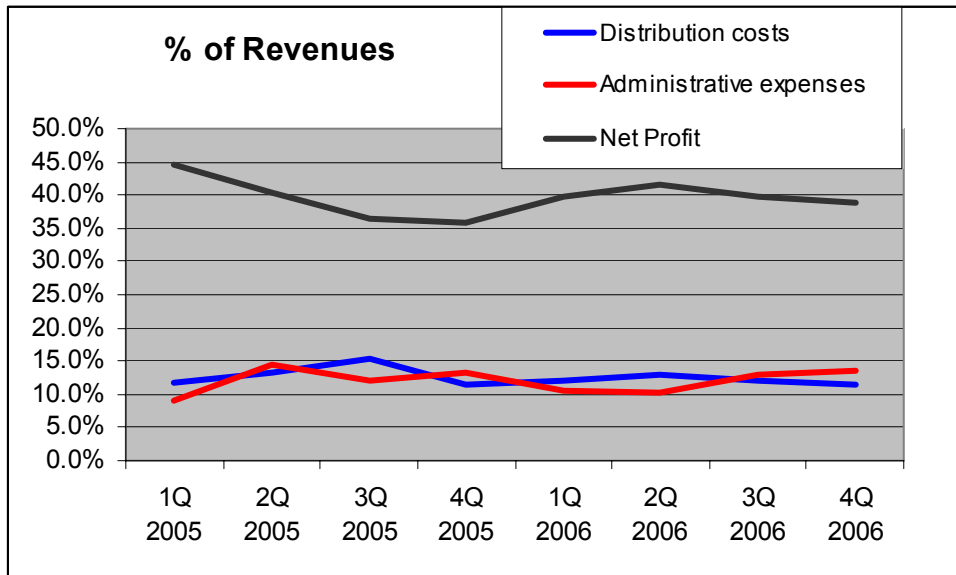
However the higher utilization of the network capacity among existing subscribers is key factor to look at going forward. We believe this will be driver of capex that will be increasing important going forward. This is separate to the more dominant and traditional capex spend on expanding network coverage and adding capacity for new subscribers.

**However as at a lower revenue per unit, balances the profit impact of Scale Economies.**

Due to the company’s strategy of reducing cost to the consumer, we believe incremental revenues from this existing base of subscribers will tend to rise at a slower pace (due to continued tariff cuts) than the rise in capacity usage. The general expectation is that scale economies would lead to reductions in varied cost factors. We feel however the benefits of this will be balanced by the fact that increased utilisation is at a falling incremental per unit revenue. We however believe the net effect will be that most cost factors as a percentage of revenue will tend to remain steady.



Source: Dialog Telekom.



Source: Dialog Telekom.

### High Inflation is a key risk factor is critical

Though the maintenance of the current cost ratios should allow Dialog to continue to show healthy earnings growth in its core mobile business with falling costs to the consumer, high inflation rates have could be a key threat to the continuation of this business strategy. In our view if inflation stabilises at above 15% annually Dialog may need to reassess its strategy of providing price cuts in absolute terms to it's consumers. We believe Dialog should then look at providing price reduction from real inflation adjusted price perspective rather than in absolute terms.

If inflation in it's underlying costs is at 15% or above, and Dialog continues to provide the original price cuts envisaged at the time of the IPO we believe the net result in the long run would be a falling EBITDA margin in it's core mobile business. This is despite the benefits Dialog is able to reap by encouraging the greater use of higher use of Value added services on the revenues side, or cost economies it is able to generate by scale economies, or innovative technical solution. Even the underlying falling costs of telephonic equipment in US\$ terms will not be sufficient in this high inflation scenario as the impact of high inflation in Sri Lanka we believe will also be reflected in the depreciation of the rupee given rising balance of payment concerns.

### We however expect to see a steady EBITDA margin

However we believe that in such an averse scenario of continued high inflation Dialog's management will most likely reassess this pricing and readjust it to maintain it's current EBITDA margins. A change in its long term pricing strategy of falling absolute pricing per minute will however need to be balanced by the



fact that its competitors in the market are getting increasingly aggressive as they need also need to dramatically increase subscriber numbers in order to justify the high network roll outs that they have embarked on. Overall however our projections for the core mobile business are based on steady EBITDA margins in 2007 and 2008, with the positives from natural scale economies being balanced by negative influences on account of falling revenue per minute and overall inflation cost pressure.

### **New subscribers will have lower ARPU's by 2008**

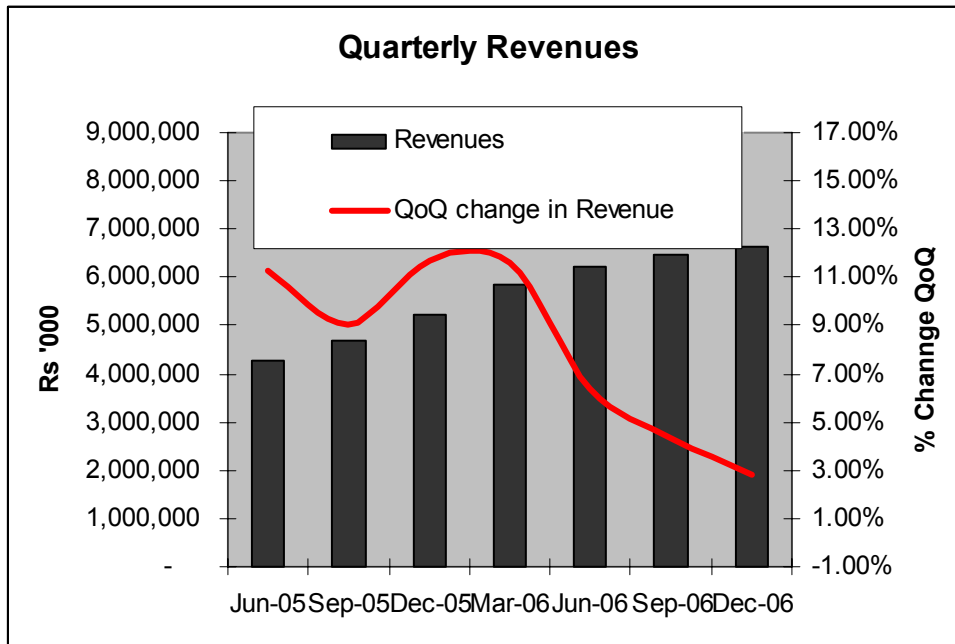
These overall effects on profitability will be reinforced by the fact that the new subscribers as penetration grows particular in 2008, may be at lower real ARPU's than that generated today by the existing subscriber base. Interestingly unlike in other emerging markets Dialog still has not seen this trend of sharp falls in ARPU's and technological innovations the company has introduced in fact has seen new subscribers sometimes register higher ARPU's than existing subscribers. However we believe with the company increasingly penetrating lower income customer segments APRU trends will revert to the usual falling trend seen in other similar markets. As a result when the country hits a penetration point of around 40% the company may need to re-e evaluate whether the demand that may still exist is economically serviceable in terms of the price point the new subscribers require connectivity at. This is particular an issue in a scenario of high inflation in general is coupled with static and falling prices for telecom services. Particular if interest rates are also high payback period will need to be very short to justify continued roll out of capacity for lower income segments.

### **Which increases payback time periods.**

The incremental capex and acquisition cost for rural subscribers added in future years may also be higher than in the past. The reason we believe for such higher incremental costs for some of these areas, is the fact tat some of the towers are being put up in very remote and hard to access areas in which there is a higher cost of setting up stand alone non grid connected power generating facilities.

### **2007 and 2008 EBITDA growth will slow though EBITDA margin is stable**

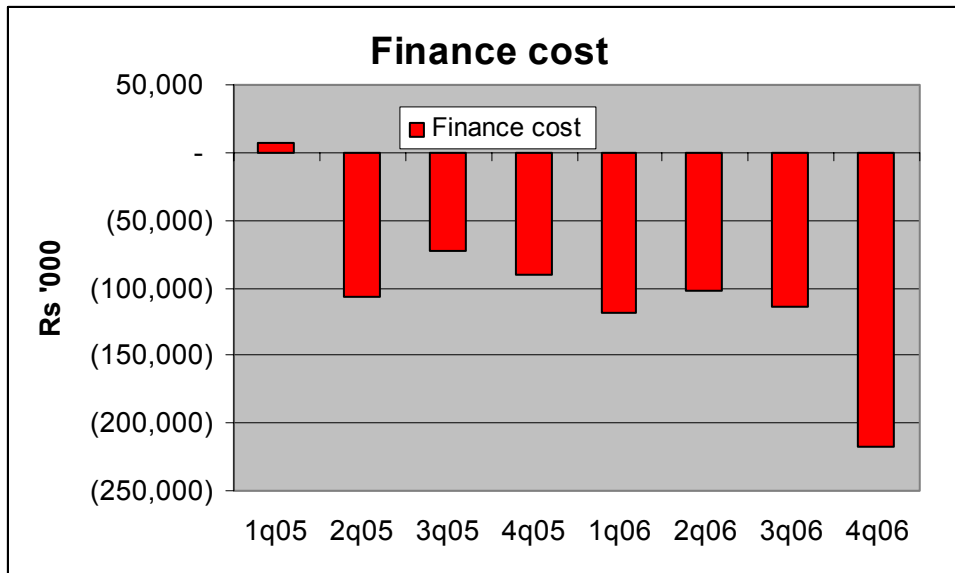
Overall therefore though we expect EBITDA margins to be steady, EBITDA growth in the core mobile business in 2007 and 2008 will be lower and in line with revenue growth. As detailed at the beginning of this report Revenue growth will be lower than in previous years on account of lower growth subscriber growth rate along with the fact that incremental subscribers will generate lower ARPU's especially at the end of the period.



**An acceleration of Dialogs investment drive will impact Net Profit Margin.**

However we believe in the next two years the key difference that will be seen in the financials will be in the falling net profit margin that Dialog as a consolidated entity will see. This will be a result of rising depreciation and interest expenses on account of it's very aggressive Capex roll out both in the core mobile as well as it's diversification into the media businesses. While triple and quadruple plays are now seen as essential businesses for a telecom player to be in, the immediate profit generation potential and paybacks of this business will be less than that seen in the core mobile business in the past Similar issues arise on the roll out of an optical fibre backbone, though it is an essential element to support both the reliability of Dialogs varied service offerings as well as provide the platform for value added services and greater data usage. Overall the financial payback on the investment that will be made in the business will be longer than that seen in the historic core mobile investment program.

Significant returns will be dependent on the speed of take up of media broadband and media services by the retail and business consumer base throughout the country. The overall impact of all this will be to significantly push up depreciation and interest expense in the next two years, and these two items are expected to rise at a far fast pace than revenue and EBITDA. The final net result at a profit level would be lower inflation adjusted real profit growth than in the past.



**Fixed line entry is the real wild card on upside.**

The one business that could mitigate this to some extent would be the revenues that could potentially be generated in the fixed line WLL business, However given that the immediate demand to a great extent has been picked up by the WLL operators and SLT it remains to be seen whether Dialog can repeat the success it demonstrated as the fourth player in mobile when it now enters the fixed line market also as the fourth player.

We therefore would remain conservative on the financial impact of Dialogs entry into this market, given that the existing players are very well aware of Dialogs strengths and have aggressively already gone after the rural and lower income consumer. Dialog’s marketing strategy, it’s pricing and financing arrangements on handset will be key and we would keep a close eye on this development in this regard. There is however the possibility of a potential upside surprise from immediate and significant contribution to profitability from fixed line entry. The Media business is also worth keeping a close watch on but we believe the larger positive surprise could come from the fixed line market.

**2009 a particularly bad year for core mobile profit growth**

Our preliminary projections indicate that 2009 could be a particularly bad year for profit growth in the core mobile operations of Dialog on account of the interplay of all the effects detailed above. With the country hitting the 40% penetration point growth, subscriber growth would be very dependent on handset costing and willingness of operators to subsidise immediate handset costing of the incremental subscribers. ARPU in real terms of any additional subscribers at that point will be low. Pressure on pricing will be most acute as at that point with new subscriber growth tapering off. We believe the four



players in the market will turn to other player markets to generate growth possibly heralding the advent of destructive pricing practises. Inflation trends could however remain strong and lead to costs growing at a faster clip than revenues, and could result in falling EBITDA margins in that year. The depreciation and interest cost of the capex made in 2007 and 2008 which would to some extent also continue in 2009 and continue to be a dampener on profits in core mobile. However Dialog clearly has taken into account this increasing challenge of generating continued profit growth in core mobile operations and by 2009 successful execution of its strategy of convergence, fixed line and broadband could see growth in profitably for the consolidated entity resume on the back of profit generation from these new ventures.

### **3G impact on incremental capex and costs**

Furthermore apart from the convergence story, we believe investors should keep a close eye on possible returns in the long term from the cost side that Dialog will see on account of the investment being made in 3G and from the optical fibre backbone. Unlike the popular view that 3G is all about data and multimedia generating higher revenues and boosting ARPU's, for Dialog we believe a key impact of the investment seen in 3G and its optical fibre backbone could be on the cost side.

### **Understanding the cost curve of 2G technology.**

The key to understanding this is related to the limitations of pre 3G technologies have in utilizing spectrum in a cost effective way when they have high usage patterns. We will later be providing a detailed report on the impacts of these technological factors as they relate to Dialog. For a basic understanding it is important to understand that in early years immediately after the first round of capex to provide coverage is met, the cost of incremental capex to meet increased usage patterns is very low and profitability of increased usage of the network is extremely high.

### **Cost Curve of incremental capacity worsens after a certain point**

However there are limitations to how much these relatively cheap ways of utilizing capacity can be used. The issue for Dialog arises in the longer term is that if it keeps seeing rising usage patterns particularly in congested areas, and particularly if users actually start actually using far more data intensive value added services. At such a point adding capacity and maintaining service quality under pre 3G technologies requires the use of increasing more expensive technological solutions including the use of micro cells which are much more expensive than the first solution of technologies such as increasing the numbers of carriers per site.



### **3G brings you back to a much better cost curve in congested areas.**

However with 3G proving to be a much more efficient arbitrator of spectrum we feel that over the medium term (post 2008) there will be cost benefits both from a capex and op-ex perspective. However for this cost reductions to have real effects a significant part of the network needs to be on 3G phones and using the 3G network. This will take time to build up and much depends on the availability of cheap 3G handsets even if only used for voice. However we believe particularly after 2009 that this could have an impact.

### **Data and ARPU impact from 3G will be later**

Currently only 6% of Dialogs revenues is from the club vision customer base (average bills over Rs13,000) who would be the first adaptors to 3G data. Over the longer term however this elite customer bases use of 3G for data could be an important but limited revenue driver adding to the positive effects of 3G on the cost side

### **Negative free cash flows in 2007 and 2008**

Our primary valuation for Dialog is on a DCF basis. Dialog has up-to now in most years been free cash floor negative and this is expected to continue in the next two years. Furthermore unlike original expectations of the market at the time of the IPO, the company will continue to make investments well in excess of internal cash generation into 2007 and 2008.

### **DCF Value in the longer term.**

Rising risk factor and inflation are now being reflected by rising risk free rate in Sri Lanka. Compared to the past when a very low interest rates significantly pushed up valuations of growth companies like Dialog, in the new economic scenario of higher interest rates there is a particular effect of the fundamental valuation of a growth company such as Dialog. With Dialog market value of equity well in excess of the book value of equity, the WACC of Dialog would also be very close to the equity discount rate. With rising political risk Sri Lankan investors would also tend to want work with a higher equity risk premium. Balance of Payment concerns and a high depreciation trends would increase the discount factor for a foreign investor who builds a discount rate from a foreign discount rate and. The overall impact of all this is that our DCF based valuation's of Dialog indicates that Dialog current share price is not attractive as positive cash flows arise only in the longer term.

Furthermore for Dialog in particular the terminal value dominates even in an eight year DCF. At later stages another risk factor is that Dialog at that point when it is generating strong positive cash flows Dialog could be a very attractive target to tax, for a state that has shown a tendency to tax sectors that



seem to generate very high levels of absolute cash flows. The BOI agreements would appear to provide Dialog protection from much taxation risk as well as the ability to switch to a favourable turnover based tax regime in later years. However in the light of the past actions of the state with regard to issues such as LIOC, sector specific “ Super taxation” of the banking system, the introduction of Economic Service charges even to the tax free BOI sector, we believe future taxation risk is very real. Presumably when Dialog it is best in a position to return money to shareholders post the earlier investment in networks, it runs the risk of state appropriation of these profits. Furthermore given that Dialog is held by foreign investors, the spectre of large amounts of capital been repatriated from Sri Lanka could raise the ire of nationalistic elements in policy making circles particularly if Balance of Payments issues are a concern at that time.

**However Dialog Management can still be the key .**

Dialogs management however has shown the ability to succeed in fast growing markets and dominate other players a later entrant. If they can fully repeat the success story they displayed in mobile, and as a late entrant create and dominate vast new profitable markets in fixed line, data, and media our pessimism on Dialogs valuation will prove premature. However at this point it still seems very optimistic to assume that Dialog can repeat the same level of success that they have in mobile in all three of these new markets, though achieving a leadership position in satellite media, while being a key player in some others maybe be realistic. Furthermore at this point competitive and technological issues would probably mean that even with success Dialog is not able to repeat similar quick paybacks to investment or the kind of ROI's it saw in mobile in these business. But we will be keeping a very close eye on Dialogs business strategy, and roll out of services so that we are in a position to reassess our view on Dialogs valuation to a more positive note if above expectation developments occur in these new markets. In our opinion the company boasts one of the most accomplished management teams, which is also very transparent and shareholder friendly, but this is well recognised by the investor community and as such is already factored into the price.

**We could be wrong on Taxation Risk while entry of index players could boost the counter.**

Dialogs management has also proved very able to avoid the taxation risk t date. As Sri Lanka's largest corporate, given its importance to overall equity markets and being a flagship of successful foreign investment to Sri Lanka, despite the attractiveness of Dialogs cash flows to tax authorities , any unfair appropriation of such cash flows would be significantly negative to the countries overall economic prospects. With Dialogs size and the growth of the Sri Lankan market the entry of index players into Sri Lanka if there is a re-entry to MSCI indexes in the longer term can continue to provide price support to the counter.

**Underweight position till likelihood of success in new markets is clearer.**

At present however though we have visibility on the issues, profitability and expectations on the core mobile business the specific financial case that returns on new business investment will continue to repeat something close to what Dialog did in the past is not clear. At a broad level we believe an investment choice in Dialog is very dependent on whether investors believe Dialog will repeat its success as a later entrant in mobile in these other segments. Dialog has the management team that can replicate such success, but specific visibility on execution and competitor response is limited. Till such visibility on these businesses is clearer we believe investors should take a strongly underweight position on Dialog. This is particularly so as the market does not take into account the potential regulatory and tax impacts to Dialog in the longer term which are more likely to impact Dialog negatively than positively.

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