

Date: 12th November 2007

## Dialog Telekom plc

## Downward revision of forecasts on account of inflationary pressures

### Recommendation Underweight

Ticker  
DIAL

Share Price\*  
Rs.23.00

Market Cap\*  
Rs187,306,901,504

52 Week High\*  
Rs.29.25

ASPI\*  
2631.43

MPI\*  
3521.71

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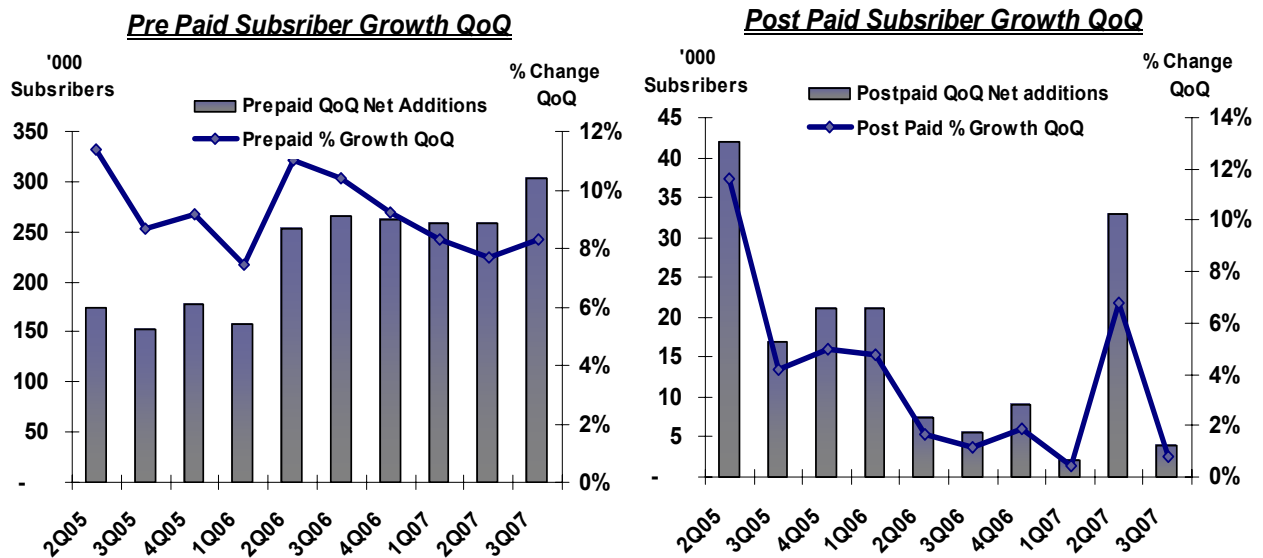
\*CSE DATA as at 12th  
November 2007

- ◆ Following 3<sup>rd</sup> quarter results that came in worse than our expectations, we have revised down our forecasts for Dialog Telekom's core mobile profitability in 2007.
- ◆ Escalating costs due to inflationary pressures have led to a fall in EBITDA margins.
- ◆ 2008 should see a better performance by Dialog's core mobile business, with the resumption of services to the eastern province and the impact of the VGS refund kicking in.
- ◆ Overall profits including the refunds are expected to rise by 49%YoY in 2008 from our revised 2007 forecast. Excluding the refund, profits are expected to rise 24%YoY.
- ◆ However in our view, 2009 will be a year in which profitability in the core business will come under severe pressure on account of penetration growth slowing down along with a further rise in the intensity of competition.
- ◆ Overall profits in the core mobile business including the VGS refund are projected to fall 19%YoY in absolute terms in 2009, while if we exclude the impact of VGS refunds there would be a fall in profits of 10%YoY.
- ◆ Furthermore given the very high level of investments, with its resultant negative impact on free cash flow, the DCF value of Dialog's core mobile operation still remains significantly below that of the current share price.

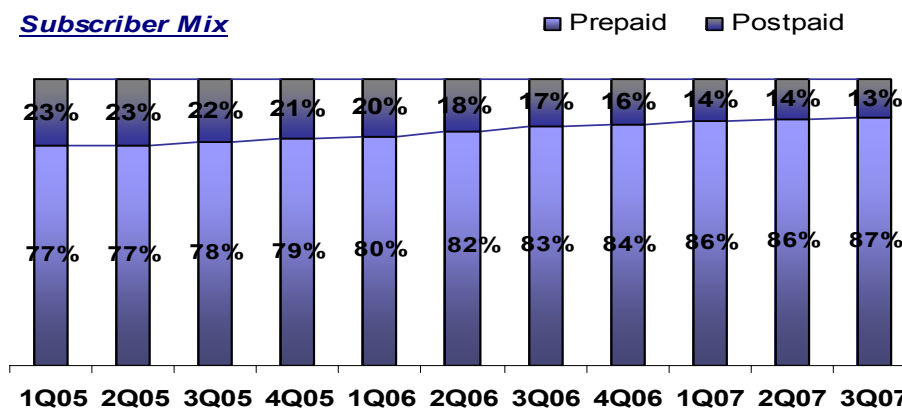
## Nine Months Results Review

### Subscriber base

For the 3Q2007 the company achieved a growth in subscriber base of 308,000, which represents an 8% growth QOQ. For the entire nine-month period under review the subscriber base grew by 28% or 859,000 to reach 3.96 million.



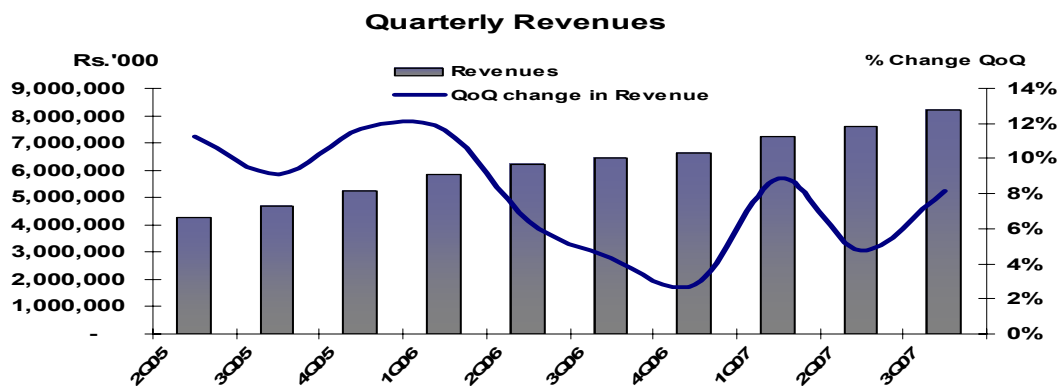
The subscriber mix skewed further towards the pre paid customer segment, continuing the trend witnessed in the previous quarters. The Post paid: Pre paid subscriber mix as at 30<sup>th</sup> Sep2007 was 13:87. Revenue contribution from the pre paid segment increased to 48% from the 42% witnessed a year ago. The post-paid segment revenue contribution for the period was 34%.



## Revenue - Group

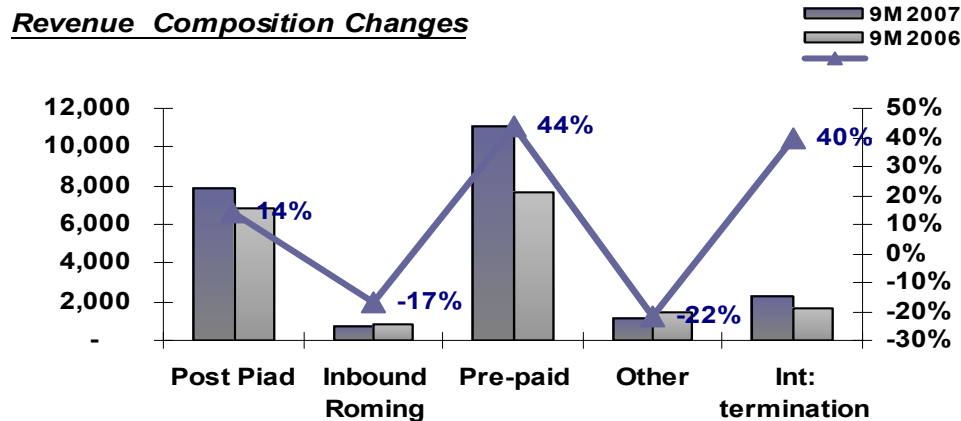
Overall group revenue increased by 27%YoY for the nine month period under review. Revenue from the company, which contributes 96% of the group's revenue increased by 24%. On a QOQ basis the company witnessed a revenue growth of 8% QOQ.

For the time period ended 30<sup>th</sup> September, the revenue from subsidiaries' increased to Rs.885 million contributing 4% of the total revenue. For period up to 30<sup>th</sup> September 2006 the revenue contribution from subsidiaries consisted only 2% of total revenue.

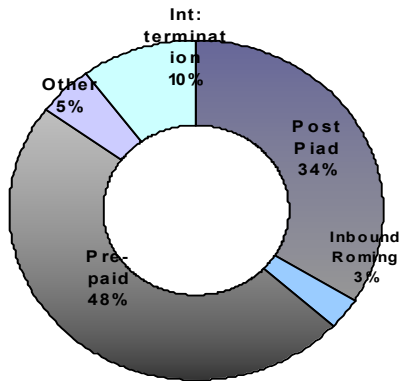


## Revenue – Company

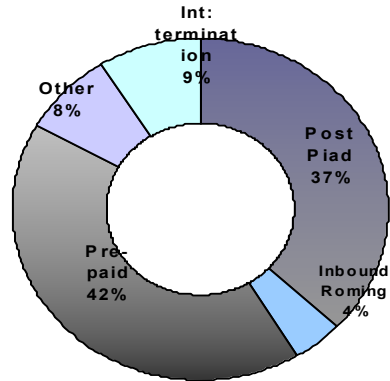
The pre paid segment saw a revenue growth of 44%YoY, whilst the International termination revenue also witnessed a healthy growth of 40%YoY. However inbound roaming revenue witnessed a sharp decline of 17%. Other sources of revenue have also dropped by 22%YoY. This segment consists mainly of revenue from sale of equipment and accessories.



**Revenue Composition for the 9 months ended 30th Sep2007**

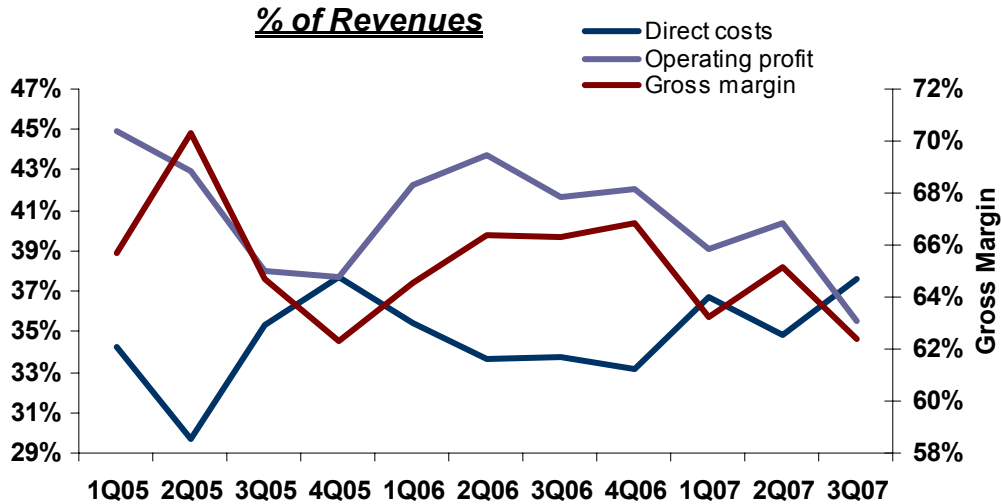


**Revenue Composition for the 9 months ended 30th Sep2006**



### Direct Cost

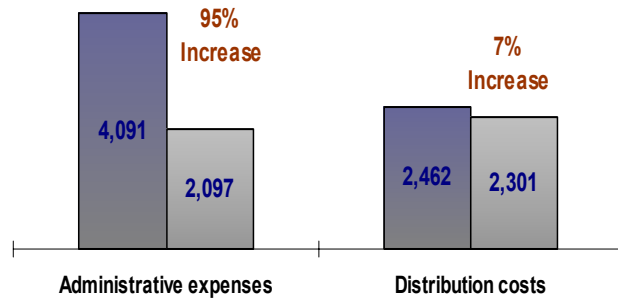
Direct costs of the group increased by 45%YoY for the period under review whilst the company's direct cost which is 97% of the group's direct cost increased by 33%YoY. This more than proportionate increase in direct cost compared to the revenue increase, resulted in the company's gross margin falling to 62%. The gross margin for the corresponding period last year was 66%.



## Operating cost

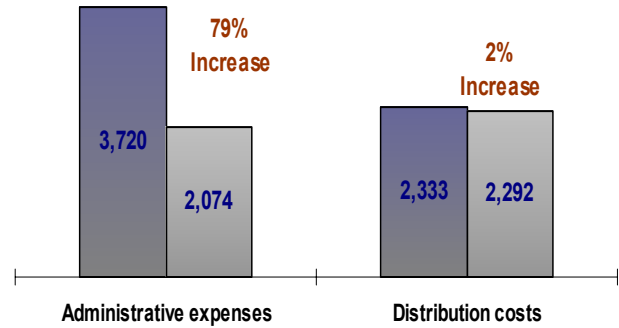
Group operating cost breakdown

■ 9M 2007  
■ 9M 2006

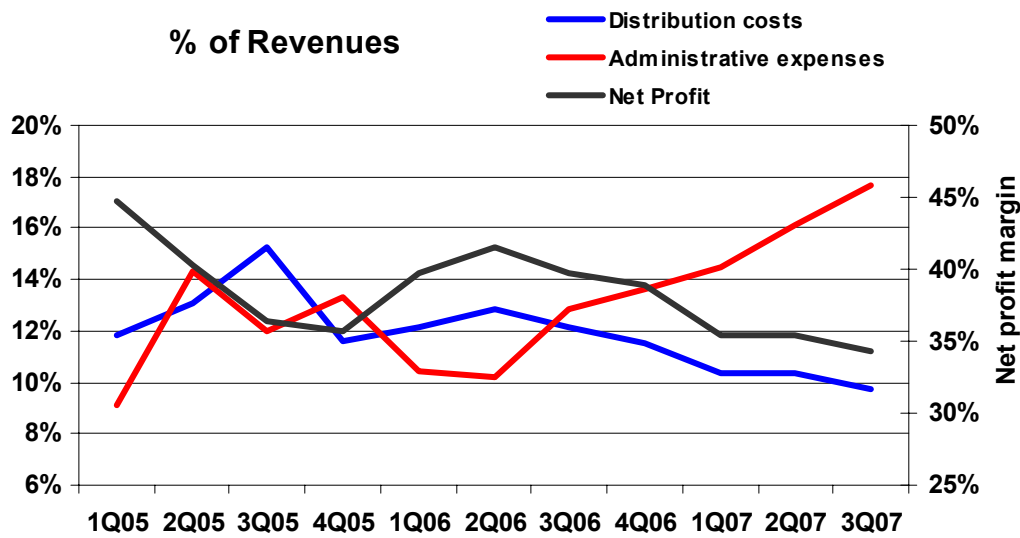


Company operating cost breakdown

■ 9M 2007  
■ 9M 2006



Total group operating cost increased by 47% for the nine month period ended 30<sup>th</sup> September 2007 relative to the corresponding period in 2006. This was led by an administration expense increase of 95%YoY. Distribution expenses increased by 7%YoY.



## Profitability

The group profitability declined by 3% for the period under review, whilst the company's net profitability increased by 7%. The decline in group profitability was due to loss of Rs.679million by the subsidiaries. Further, due to the increase in company's share capital and the decline of profits, the EPS(group results) declined by 9% compared to the EPS achieved in the same period of last year.

As depicted in the table below, the profit margins of the company have declined over the period, mainly due to escalating costs on account of inflation, coupled with the severe drop in revenues from the North Eastern markets and inbound roaming.

	Group		Company	
	9M2007	9M2006	9M2007	9M2006
Gross margin	14,484	12,364	14,640	12,168
<b>GP Margin</b>	<b>61%</b>	<b>65%</b>	<b>64%</b>	<b>66%</b>
Operating profit	8,144	8,049	8,724	7,865
<b>OP Margin</b>	<b>34%</b>	<b>43%</b>	<b>38%</b>	<b>43%</b>
EBTDA	10,863	10,059	11,302	9,797
<b>EBTDA Margin</b>	<b>45%</b>	<b>53%</b>	<b>49%</b>	<b>53%</b>
Net profit	7,304	7,549	7,983	7,549
<b>NP Margin</b>	<b>31%</b>	<b>40%</b>	<b>35%</b>	<b>41%</b>

## Forecast Revision Summary.

In our February Report in which we initiated coverage on Dialog with a strongly underweight recommendation, we highlighted the dangers posed by high inflation to the profitability of Dialog's core mobile business.

*"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 its consumers. We believe Dialog should then look at providing price reductions from real inflation adjusted price perspective rather than in absolute terms. "*

*"If inflation in its 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 sharply falling EBITDA margin in its core mobile business. This is despite the benefits Dialog is able to reap by encouraging the greater use of Value added services on the revenues side, or cost economies it is able to generate by scale economies, or innovative technical solution.*

However at that time we took an optimistic assumption of lower inflation levels than those seen currently. As such we are revising down our forecasts for Dialog's core mobile operations (company only) as detailed below.

### Summary of Forecast Changes for Dialog Telekom plc

	2007E	2008E	2009E	2010E
<b>Turnover(Previous)</b>	32,706	40,181	45,318	51,191
YoY%	30%	23%	13%	13%
<b>Turnover(Revised)</b>	32,036	40,210	45,399	51,167
YoY%	27%	26%	13%	13%
<i>Change in Forecasts</i>	-2.1%	0.1%	0.2%	0.0%
<b>EBITDA(Previous)</b>	17,471	24,484	24,263	27,551
YoY%	31%	40%	-1%	14%
<b>EBITDA(Revised)</b>	15,688	23,598	24,021	27,257
YoY%	17%	50%	2%	13%
<i>Change in Forecasts</i>	-10.2%	-3.6%	-1.0%	-1.1%
<b>PAT</b>	12,443	17,611	15,009	17,374
YoY%	23%	42%	-15%	16%
<b>PAT(Revised)</b>	11,360	16,924	13,738	16,020
YoY%	12%	49%	-19%	17%
<i>Change in Forecasts</i>	-8.7%	-3.9%	-8.5%	-7.8%
<b>PAT Excluding VGS Refund</b>	12,168	14,419	13,806	15,989
YoY%	21%	18%	-4%	16%
<b>Revised PAT Excluding VGS Refund</b>	11,092	13,776	12,418	14,501
YoY%	10%	24%	-10%	17%
<i>Change in Forecasts</i>	-8.8%	-4.5%	-10.1%	-9.3%

### 2008 will see a strong recovery

With a recovery in the North Eastern market and the inclusion of the VGS refund amount, we expect margins and profit growth to recover sharply in 2008. Overall profits including the refunds are expected to rise by 49%YoY in 2008. Excluding the refund, profits are expected to rise 24%YoY. We have assumed that Dialog will continue to maintain its current market share on a revenue share projection basis, to reflect our confidence in Dialog's management capabilities in responding to the increasingly competitive pressures in the market. Despite rising competitive pressure keeping revenue per minute at current levels, rising minutes of use lead us to assume a rise of 1% ARPU levels in absolute terms in the Pre Paid Market and a small 5% increase in ARPU in the Post Paid Market.

### To be followed by a very challenging 2009

However though we expect to see healthy profit growth in 2008, we continue to reiterate our view that *“2009 could be a particularly bad year for profit growth in the core mobile operations of Dialog”*. 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 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 continue into 2009 and continue to be a dampener on profits in core mobile operations. “

Overall profits in the core mobile business including the VGS refund are projected to fall 19%YoY in absolute terms in 2009, while if we exclude the impact of VGS refunds there would be a fall in profits of 10%YoY. However Dialog clearly has taken into account this increasing challenge of generating continued profit growth in real terms in the core mobile operations, and by 2009, successful execution of its strategy of diversification to, fixed line and broadband could see growth in profitably for the consolidated entity, to resume as a result of profit generation from these new ventures. However as explained earlier in previous reports even though new ventures will lead growth in profits of Dialog as a consolidated entity post 2009, the implied value of their subsidiary operations today at current discount rates appears too high and as such we retain our underweight recommendation.

	2007E	2008E	2009E	2010E
NP margin	35%	42%	30%	31%
NP margin ex Refund margin	35%	34%	27%	28%
GP margin	64%	70%	61%	61%
EBITDA margin	49%	59%	53%	53%
EBITDA ex Refund margin	48%	51%	50%	50%
EPS Basic	1.39	2.07	1.68	1.96
EPS Excluding the Refund	1.36	1.69	1.52	1.78
DPS Basic	0.42	0.62	0.50	1.66

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