

Dialog Telekom

Date
1st August 2007

Recommendation
Underweight

Ticker
DIAL

Share Price*
Rs.22.25

Market Cap*
Rs.181,199 Mn

ASPI*
2429.83

MPI*
3340.87

Analysts
Amal Sanderatne,
CFA

Varuni De Silva

Low valuation due to high interest rates

- We are retaining our underweight recommendation on the counter as the high interest rate environment places a significant discount on the valuation of a company investing heavily in growth such as Dialog.
- For our valuation we have initially projected the cash flows of the company on a non consolidated basis until 2007 and taken a terminal growth rate assumption after that point.
- Dialog's valuation is highly sensitive to the level of discount rates as it will start to generate significant free cash flows only after 2010. As these cash flows are been discounted at high interest rates, the valuation of the company is very sensitive to the discount rate used.
- Under our base case cost of equity figure of 24% and terminal growth rate beyond 2017 of 16% Dialog's core mobile operations are valued at Rs11.9 per Share.
- We have not projected the cash flow of the company's subsidiaries at this point but on our base case discount rates and terminal value, the valuation gap between the current Rs.22.25 trading price of Dialog and that of the discounted company cash flow value of Rs.11.9 would suggest an implied value to the companies subsidiaries of Rs.84 billion which would appear rather optimistic.



Investment Thesis

Retaining Underweight recommendation on account of high interest rates

Though Dialog has displayed some resilience to conflict and macro impacts on its performance in the first half, we are retaining our underweight recommendation on the counter as the high interest rate environment places a significant discount on the valuation of a growth company such as Dialog.

Dialog's valuation is particularly sensitive to the level of discount rates as the company is in a heavy investment drive until 2009 and starts generating significant free cash flows only after 2010. As these cash flows have been discounted at high interest rates, the valuation of the company is very sensitive to the discount rate and has been reduced sharply on account of the high interest rate environment.

Dialog core mobile operations valued at Rs.11.9 per Share.

For our valuation we have initially projected the cash flows of the company on a non consolidated basis until 2017 and taken a terminal growth rate assumption after that point. As it is a valuation of company cash flows only, this is a valuation of the core mobile operations of the business and does not include cash flows from its broadband, media and fixed line businesses. We used a free cash flow to Equity valuation as the leverage of the company based on market value based calculations of the debt and equity components showing a very low leverage ratio at present. Under our base case cost of equity figure of 24% and terminal growth rate beyond 2017 of 16%, Dialog's core mobile operations are valued at Rs.11.9 per Share.

However a very high sensitivity to discount rate used

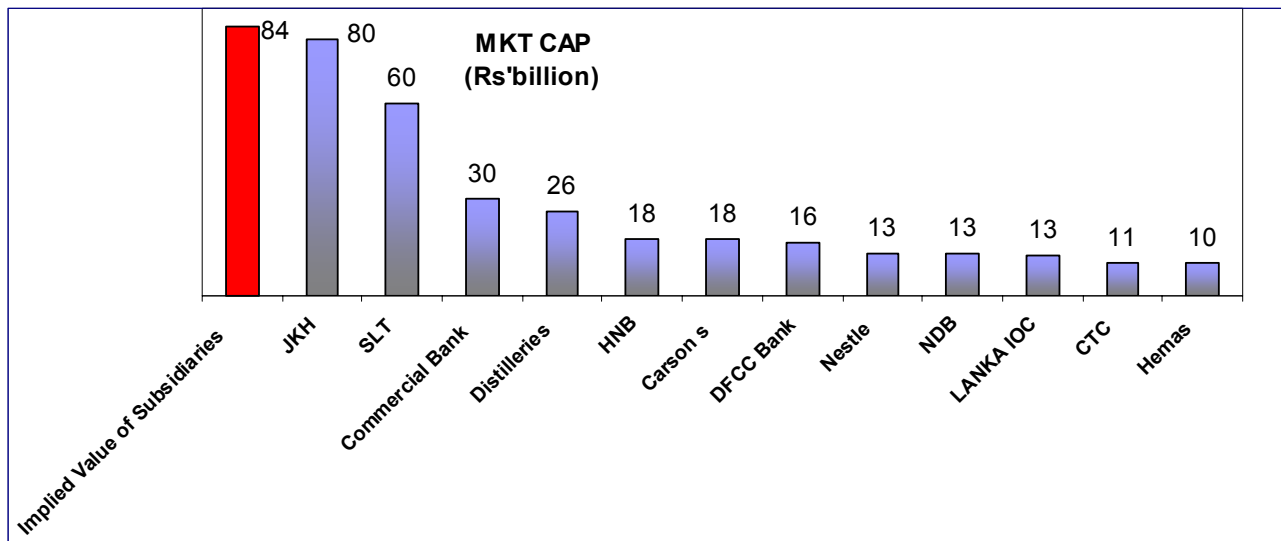
However as can be seen in the graphs below, this valuation is extremely sensitive to the discount rate used. Thus a 300 basis point reduction in the risk free rate would increase the value of the Core Mobile Business to Rs.21.9, which is close to the current share price and without the value of the subsidiaries being factored in. However a further 100 basis point increase in the risk free rate would see the value of the core mobile business fall to Rs.10.1 per share.

Sensitivity of FCFE valuation

Terminal growth rate	COE						
	21.0%	22.00%	23.00%	24%	25%	26%	
13%	15.2	12.8	11.0	9.5	8.3	7.2	
14%	16.8	14.0	11.8	10.1	8.7	7.6	
15%	18.9	15.5	12.9	10.9	9.3	8.1	
16%	21.9	17.4	14.3	11.9	10.1	8.6	
17%	26.4	20.2	16.1	13.1	11.0	9.3	
18%	33.9	24.4	18.6	14.8	12.1	10.1	

The gap between market value and that of core mobile operations seems too high to be compensated by value of new businesses

We have not projected the cash flow of the company's subsidiaries at this point but on our base case discount rates and terminal value, the valuation gap between the current Rs.22.25 trading price of Dialog and that of the discounted company cash flow value of Rs.11.9 per Share, would suggest that the implied value placed on the company's subsidiaries is Rs.84 billion. To put this into context, we have compared the implied valuation of the subsidiaries and of the new business lines the company is getting into with the market caps of some of the other counters listed on the CSE.



1st Half Results Review

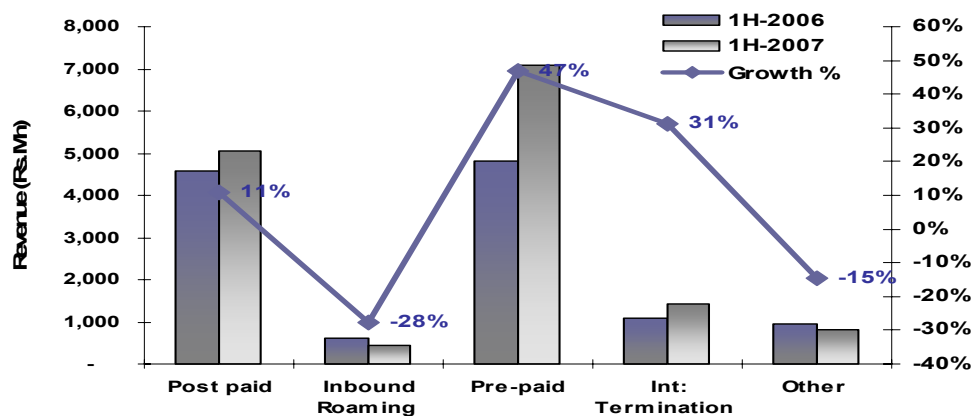
Subscriber base

For the first half of 2007 despite the disruption to key growth markets in the North and East, the company increased its subscriber base to 3.6 Million. This is an increase of 43% YOY. 95% of this growth came from the pre paid segment which witnessed a growth of 50%YoY on its subscriber base. The post paid segment witnessed a growth of 11% YOY. However ARPU levels witnessed slight drops. Blended ARPU dropped by 12%YoY while the pre paid ARPU and post paid ARPU dropped by 4%YoY and 0.2%YoY.

Revenue - Group

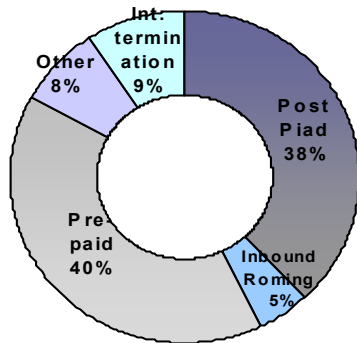
Overall group revenue increased by 25%YoY whilst the company's revenue which contributes 95% of the group's revenue increased by 23% YOY. On a QOQ basis both the group and the company witnessed a revenue growth of 5% QOQ. The revenue from subsidiaries has seen a decline of 1% QOQ. The growth in revenue has come despite the disruption to North and East markets during the first half of the year, which previously amounted to 7% of the company's total revenues.

Revenue - Company

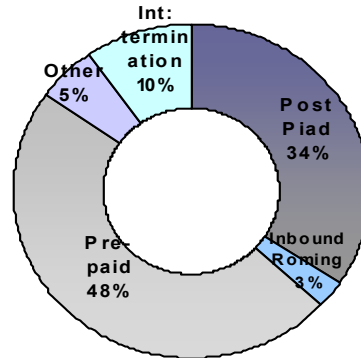


The pre paid segment saw a revenue growth of 47%YoY, whilst the International termination revenue also witnessed a healthy growth of 31%YoY. However inbound roaming revenue witnessed a sharp decline of 28%. According to the company this was due to the drop in inbound tourist arrivals to the country. Other sources of revenue have also dropped 15%YoY. This segment consists mainly of revenue from sale of equipment and accessories.

Revenue Composition 1H2006



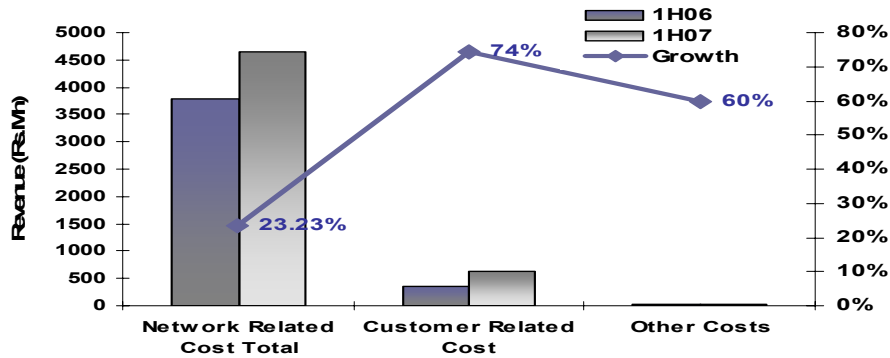
Revenue Composition 1H2007



Direct Cost - Group

Direct cost of the group increased by 39%YoY for the 1H2007 whilst the company’s direct cost which consists of 89% of the groups direct cost increased by 28%YoY. On a QOQ basis, the group’s direct cost increased by 3% QOQ whilst the company’s direct cost decreased by 1%QoQ.

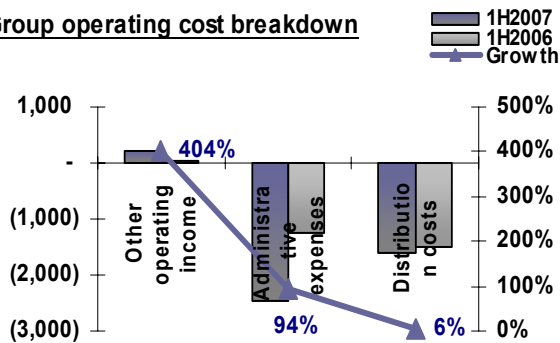
Direct Cost - Company



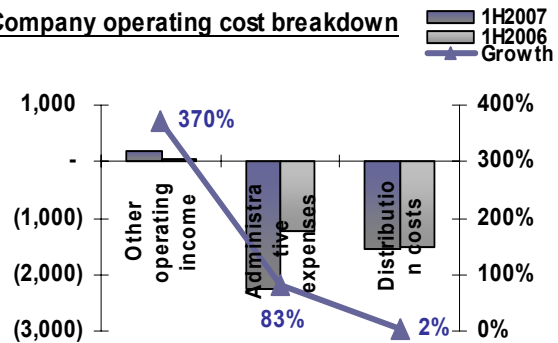
Network related cost which represents 88% of the direct cost, showed a consistent growth to the growth in revenue of 23%YoY. However customer related cost showed a sharp increase of 74%YoY. Compared to 2Q2006, the 2Q2007 direct cost of the company showed an increase of 27%.

Operating cost

Group operating cost breakdown



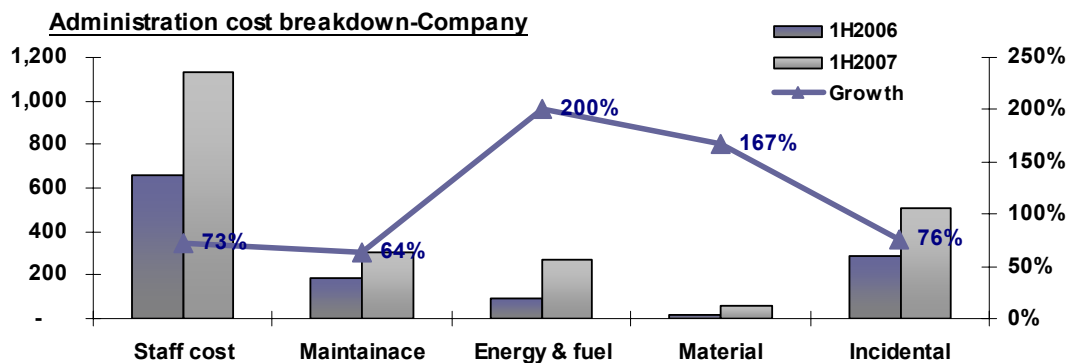
Company operating cost breakdown



Total operating cost increased by 40% for 1H2007. This was led by an administration expense increase of 94%YoY. The distribution expenses increased by 6%YoY.

Operating Cost-Company

The main factor for the huge increase in operating expenditure was the increase in Staff cost. Staff cost which was 5.44% of the revenue in the 1H 2006 has increased to 7.63% of revenue, a 73% increase YOY. Further as we projected in our initial detailed report in February, the high inflation environment has negatively impacted the company's other operating cost such as maintenance, energy, material etc.

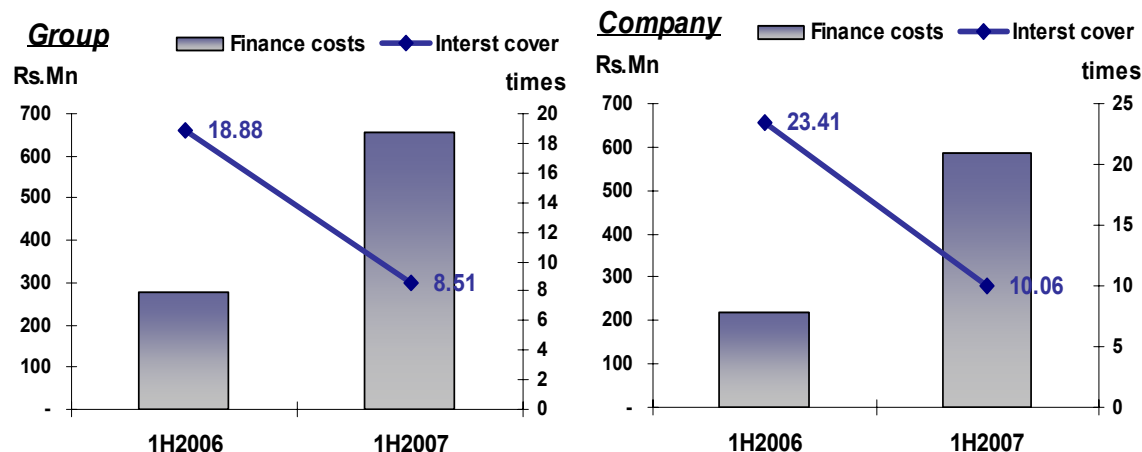


International Telecom levy Claim

In the statement for the first half of the year, the company estimated that "The total value of Dialogs entitlement is estimated to be Rs1.92 Bn for the period from March 2003 to 30th June 2007. Based on the guidelines issued by the TRCSL for refunding claims, Dialog has submitted its refund claim for 2003 & 2004. The refunds once paid will be reflected as cost reversal." Our forecasts for this year assume a Rs200million refund been accounted for as a cost reversal for this year.

Finance Cost

Finance cost has climbed up by 135% for the 1H2007 YOY. For 1H2007 the interest cover (finance cost cover) of the company decreased by 55% to 8.5 times from 18.8 times in 1H 2006. For the company the interest cost increased by 165% YOY and the Interest cover reduced to 10 times from 23.4 times in 1H2006. The interest cost burden however will be far less of an issue going forward on account of the infusion of equity funding from the rights issue.



Profit Margins

As depicted in the table below, the profit margins of the company has 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	
	1H2007	1H2006	1H2007	1H2006
Gross margin	9,422	8,009	9,522	7,879
GP Margin	61%	65%	64%	65%
Operating profit	5,588	5,277	5,893	5,171
OP Margin	36%	43%	40%	43%
EBTDA	7,237	6,596	7,457	6,395
EBTDA Margin	47%	54%	50%	53%
Net profit	4,868	4,933	5,253	4,885
NP Margin	32%	40%	35%	41%

Outl



Outlook for the next three years

With a recovery in the North Eastern market we expect margins and profit growth to recover sharply in 2H2007 and 2008. The refund of the VGS levy for previous years will see a Rs200m boost to profitability this year and a Rs2,112 billion in 2008. Overall profits including the refunds are expected to rise by 23%YoY in 2007 and 36%YoY in 2008. Excluding the refunds profits are expected to rise 21%YoY and 14%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 given our very positive view on Dialog's management capability, in the immediate future we have assumed the maintenance of ARPU levels in absolute term the Pre Paid Market and a small increase in ARPU in the Post Paid Market.

Though the maintenance of the current cost ratios should allow Dialog to continue to show healthy earnings growth in its core mobile business into 2008 with falling costs to the consumer, high inflation rates however could be a key threat to the continuation of this business strategy and could prove our forecast too optimistic. As detailed in our February report *"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. 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 giving rising balance of payments concerns."

2009 a particularly bad year for core mobile profit growth

However though we expect to see healthy profit growth in 2H 2007 and 2008, we reiterate the view expressed in February 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 9% in absolute terms in 2009, while if we exclude the impact of VGS refunds there would be a rise in profits of only 3% far bellow inflation projections of around 10%. 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 even though new ventures will lead growth in profits of Dialog as a consolidated entity post 2009, the implied value of the operations today at current discount rates appears far too high.

Summary Profit Forecast (Core Mobile-Company Only)

	2004	2005	2006	2007E	2008E	2009E	2010E	2011E
Turnover	11,407	18,034	25,149	32,706	40,286	46,106	52,270	57,903
YoY%	53%	58%	39%	30%	23%	14%	13%	11%
Direct costs	3,932	6,214	8,536	11,141	12,357	18,057	19,530	21,222
YoY%		58%	37%	31%	11%	46%	8%	9%
Gross Profit	7,475	11,821	16,613	21,565	27,929	28,049	32,740	36,682
YoY%		58%	41%	30%	30%	0%	17%	12%
EBITA	5,917	9,416	13,362	17,471	24,467	24,586	28,017	30,736
YoY%		59%	42%	31%	40%	0%	14%	10%
PBT	4,140	7,054	10,105	12,443	16,930	15,401	18,748	21,346
YoY%		70%	43%	23%	36%	-9%	22%	14%
PAT	4,140	7,054	10,105	12,443	16,930	15,401	18,748	21,346
YoY%		70%	43%	23%	36%	-9%	22%	14%
PAT Excluding VGS Refund		7,012	10,049	12,168	13,821	14,284	17,457	19,863
YoY%			43%	21%	14%	3%	22%	14%

	2004	2005	2006	2007E	2008E	2009E	2010E	2011E
NP margin	36%	39%	40%	38%	42%	33%	36%	37%
NP margin ex Refund margin			40%	37%	34%	31%	33%	34%
GP margin	66%	66%	66%	66%	69%	61%	63%	63%
EBITDA margin	52%	52%	53%	53%	61%	53%	54%	53%
EBITDA Margin ex VGF Refund		52%	53%	53%	53%	51%	51%	51%
EPS Basic	110.82	0.95	1.36	1.52	2.07	1.88	2.29	2.61
EPS Excluding the VGF Refund		0.95	1.36	1.49	1.70	1.75	2.14	2.44
DPS Basic	23.41	0.39	0.38	0.46	0.62	0.56	1.83	2.34

CAPITAL ALLIANCE 5th Floor, Millennium House, 46/58 Nawam Mawatha, Colombo 2, Sri Lanka
Tel: +94 11 231 7766, Fax: +94 11 231 7788, Email: general@capitalalliance.lk
For further information, please contact:

Saliya Gamagedera: +94 11 231 7760
Lakshan Algama Perera: +94 11 231 7760
Harsha Gunawardena: +94 11 231 7716
K. H. R. Thilakarathna: +94 11 231 7752
Sudam Hasantha: +94 11 231 7755
Lulith Karunaratne (Matara) : +94 41 439 0610
Sandeep Fernando: +94 11 231 7716

W. A. Susantha: +94 11 2317757
Dumindu Silva: +94 11 2317753
Gawri Kathriarachchi: +94 11 231 7716
Rizwana Aazim: +94 11 231 7758
Chanaka Sanoj: +94 11 231 7755
Inok Wijesuriya (Matara):+94 41 439 0610
B. Mugundan (Jaffna): +94 21 459 1111

The analyst responsible for producing the report does not work for Capital Alliance Securities (Private) Ltd. This report has been produced as part of an outsourced research relationship with a specialized research company engaged by Capital Alliance Securities (Private) Ltd. This document has been prepared and issued on the basis of publicly available information, internally developed data and other sources, believed to be reliable. Capital Alliance Securities (Private) Limited however does not warrant its completeness or accuracy. Opinions and estimates given constitute a judgment as of the date of the material and are subject to change without notice. This report is not intended as an offer or solicitation for the purchase or sale of any financial instrument. The recipient of this report must make their own independent decision regarding any securities, investments or financial instruments mentioned herein. Securities or financial instruments mentioned may not be suitable to all investors. Capital Alliance Securities (Private) Limited it's directors, officers, consultants, employees, outsourced research providers associates or business partner, will not be responsible, for any claims damages, compensation, suits, damages, loss, costs, charges, expenses, outgoing or payments including attorney's fees which recipients of the reports suffers or incurs directly or indirectly arising out actions taken as a result of this report. This report is for the use of the intended recipient only. Access, disclosure, copying, distribution or reliance on any of it by anyone else is prohibited and may be a criminal offence.