PLDT/SMART/PILTEL---- "PLAN 25/8": THE GIANT THROWS A "MANILA ICE"

Finally, the giant (PLDT Group) fights back by throwing the right hook. It is the secret weapon of Manny Paquiao coined as "manila ice" by Freddie Roach (Manny Paquiao Trainer).

SMART/Piltel recently announced its own version of unlimited calls and text called "Plan 25/8" which is a nice pun to Sun Cellular's "24/7" program. The "giant's" entry into the pricing melee, will most probably result in a loss in market share for Globe and SUN (Digitel) given SMART/Piltel's competitive advantage in terms of both network and subscriber base.

We like the way the promo was priced and structured relative to the promo of Globe and SUN (Digitel). The fact that SMART/Piltel entered the fray only after Digitel and Globe is indicative that they have studied the weaknesses of the previous two promos and have tailored themselves to have a better operational effectiveness.

Given these developments, we reiterate our BUY rating for PLDT (direct play into SMART) and Piltel as this would ultimately result in a higher subscriber base and stronger growth prospects.

For the rest of the article, we would like to highlight and discuss the prospects of PILTEL Corporation (PLTL). We think there is more to Piltel than the "25/8" promo as the stock is currently undervalued and has good growth prospects------a clear GARP play.

Year to date, the stock is among the best performing counters in the Philippine equity market as it has so far posted a gain of 42.3% for the year versus the Phisix which has gained by 17.28%. That's a relative price performance of 2.47x versus the index.

The main catalyst for this run up has been last January's announcement of a new revenue sharing scheme revising the previous 50/50 arrangement between Smart and Piltel to an 80/20 scheme in favor of Piltel. This decision has been like a "manna from heaven" for company which has been languishing from the previous 50/50 arrangement.

With this change in revenue sharing scheme, it has ultimately resulted in a surge of 18.1% in recurring top line revenues for FY2004 and resulted in a one time P3.7 billion increase in revenues based on prior period adjustment. All this translated to a net income of P9.75 billion for Piltel in 2004 versus a net loss of P3.38 in 2003 and another net loss of P22.24 billion in 2002.

On the other hand, a company like Digitel, while it had initially been reaping benefits of the lower price schemes, may eventually be adversely affected earnings wise as its subscriber base hits a "critical mass" given its lower network capacity. Any share price increase on Digitel would be mainly driven by news of potential strategic partners rather than fundamentals of increasing subscriber base that we relied on before the onslaught of Globe and SMART.

Here are the reasons why we think the stock merits a BUY…..

- Direct play in the country's largest cellular network

Our wireless telecom sector has been one the fastest growing sectors in Asia and its growth models in the aspect of prepaid and SMS is currently being followed by countries like Malaysia and Indonesia. Globe, PLDT and Digitel are the three stocks that offer a play in the wireless telecom sector of the country (with SMART being unlisted). However, these companies have fixed line components where growth is not as rapid. Piltel is the only pure wireless play in this fast growth sector.

- PILTEL is better equipped in a price war

One of the risks of investing in the telecom sector at this point is the impending price war which will reduce margins and profitability. Globe has been the most adversely affected by this as its 2004 numbers shows a recurring income of only about P12 billion versus the consensus estimate of about P15 billion.

Given this pricing war, companies with operating efficiencies and economies of scale (network strength, subscriber base etc) would have a clear advantage. As such, PILTEL is in a much better competitive position relative to its competitors given its access to SMART's network (largest in the country) and its portability to SMART's over 20 million subscriber base.

- Turn around story and further incentives to growth

With the new revenue scheme, Piltel is a clear turn around story from a company riddled with debt and low profitability into a company with an improved debt position, increased growth and profitability. In addition, we also would like to note that revenue schemes can go higher than the 80/20 arrangement to as high as 85/15 if Piltel can achieve its revenue targets.

Given this revenue incentive, upward revisions in earnings is likely especially if Piltel (along with SMART) continues to "eat up" market share of its competitors with the recent Plan 25/8.

- CHEAP valuations, Fair Value at P8.48

Based on our estimates of a P0.70 EPS '2005 target for Piltel, the stock is trading at a Forward PE of 5.5x. which is a 60% discount to the current market PE of 13.5x. In terms of relative valuation, we have included below a table which compares Piltel's valuation metrics to other comparable companies in the local market, in the region and in the U.S.

From a regional stand point, the industry (wireless telecom) is averaging at 13.9x 2005PE which is a significant premium to Piltel. Aside from PE, Piltel is trading at a discount in terms of PE to growth (PEG) as the regional PEG is at 2.04 and the other Philippine players is at 0.31x. The PEG of Piltel which is at 0.06x. As seen from the comparative chart below, PILTEL has the lowest PEG among wireless players in the world.

From this table, we can see that Piltel is the cheapest of all comparative metrics in terms of both value and growth. We would like to highlight that aside from absolute PE and growth valuation, Piltel has the highest margin in the region with an EBITDA (Earnings before Interest, Taxes and Depreciation/Amortization) of 57.24%.

Piltel is trading at a steep discount in terms of our 5yr Discounted Cash Flow (DCF) model. We estimate a fair value of P8.48 for Piltel which translates to a Fwd PE (2005FY) of 12.1x, a discount to market. For the DCF model, we assumed a discount factor of 15% which is conservative considering that our Weighted Average Cost of Capital (WACC) estimates were at 12.5%. In short, the fair value can go to as high as P10-P12 range if we use a lower discount factor in our estimated cash flow streams based on our sensitivity analysis.

While we still have our concern on the imminent pricing war and cannibalism in market share, we believe the PLDT group (including SMART and Piltel), being the giant as it is, will emerge "victors" because of its economies of scale and its operational efficiencies.

However, the fact that the PLDT group (SMART/PILTEL) has decided to face the competition head on in this pricing war is a key positive. Rather than being passive and letting competition erode its subscriber base, PLDT (SMART/PILTEL) is fighting back.

*****COMPARATIVE TABLE HERE***********************

In the next section, we would like to discuss another valuation metric called PE to Growth or PEG. This metric essentially measures the relationship between the stock and market PE in relation to its growth. The reasoning behind this is that certain companies can be priced by the market at a high PE valuation (Premium to market) mainly because of the company's strong earnings growth. In the mean time, there are some companies that are priced at very low PEs because there is little or no growth in terms of earnings for that company.

The computation for PEG is taking the stock PE divided by its growth rate. In the case of Piltel, for example, the company is trading at 5.5x PER and a growth rate of 84.7%. The PEG ratio then would be 0.06x (Divide 5.5 by 84.7), one of the cheapest in the world.

"Manny Paquiao's secret weapon….“manila ice” is a right hook”….Freddie Roach (Manny Paquiao Trainer)

“Getting hit motivates me….it makes me punish the guy more….a fighter takes a punch, hits back with three punches” Roberto Duran