Australian National University

ANU Student Managed Fund

Investment recommendation

Telstra Corporation Limited

ASX code: TLS

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Notes:

All dollar amounts in this report are Australian dollars.

Glossary

AA – Asset allocation

AAE – Active Australian equities

ANU – The Australian National University

ARPU – Average revenue per user

CBE – ANU College of Business and Economics

EBIT – Earnings before interest and taxes

FC – Franking credits

FY – Financial year

GW – Goodwill

IC – Invested capital

IOZ – iShares Core S&P/ASX 200 ETF

MoS – Margin of safety

NBN – National broadband network

NOPLAT – Net operating profit less adjusted taxes

ROIC – Return on invested capital

SMF – ANU Student Managed Fund

TLS – Telstra Corporation Limited

T22 – Telstra's corporate strategy from 2016 to 2022

T25 – Telstra's corporate strategy from 2022 to 2025

WACC – Weighted average cost of capital

Portfolio recommendation

We recommend that the Student Managed Fund (SMF) **sell** its entire active position in Telstra Corporation Limited (TLS) as held within the Active Australian equities (AAE) portfolio, and invest the proceeds in the iShares Core S&P/ASX200 ETF (IOZ).

Our sell recommendation is conditional on either: (a) the share price remaining above $3.34 (implying a -5% margin of safety, or MoS); or (b) the share price being between $3.17 (implying a 0% MoS based on current assumptions) and $3.34, and TLS having outperformed the IOZ by 5% from the date of this report. The second condition recognises the possibility of market-driven weakness associated with higher interest rates and a higher cost of capital.

AUSTRALIA	
ASX code: TLS	
Price (at 29/09/2022)	A$3.85
Valuation	$3.17
- inc. franking credits	$4.26
Margin of safety (MoS)	-17.74%
- inc. franking credits	10.63%
Dividend yield (2022F)	4.38%
- inc. franking credits	6.09%
GICS	Communication Services
52-week range	A$3.62 -A$4.31
Recommendation	**Sell**
Key assumptions	
Required return on equity	6.75%
WACC	6.11%
Carbon intensity	
TLS	72.30
ASX200	236.08

Five-year share price history

Investment thesis

The key reason for our sell recommendation is that the growth, margins, and return on invested capital (ROIC) necessary to justify a price of $3.85 are unlikely to be attained in the current competitive market.

Our 'market model', which reflects our interpretation of what the market is pricing in, suggests the following would be needed to justify the current TLS share price:

- Revenue growth greater than 2% p.a. through the 10-yr forecast period;
- EBIT margins rebounding from 13.73% to 19.3% within 5 years; and,
- ROIC (excluding goodwill) returning to 14%-15% by 2027, near to its pre-NBN levels of 17%-18%. ROIC is currently below 9%.

Falling short of these expectations would put downward pressure on the share price. We see this outcome as a distinct possibility given continuing competition in the industry, with Optus, TPG and Aussie Broadband competing with Telstra on price and quality. Because of this competitive environment, sustained re-investment in the business has been flagged as an important aspect of TLS' T25 strategy. This re-investment, coupled with the expectation of 2% p.a. revenue growth, appears to conflict with the market's expectations for a rebound in ROIC in excess of 5%.

This report starts by showing that TLS is trading on a high price/earnings ratio (P/E) relative to both its own history and the market. We then discuss our forecasts and scenario analysis, delving into whether TLS can generate the cash flows necessary to justify its current share price. We show how the growth, margins, and ROIC expected by the market appear optimistic and more likely to be met with disappointment than exceeded. Finally, we consider the plausibility of the assumptions embedded in brokers' broadly bullish forecasts. Taken together, this analysis reveals that TLS is priced for optimism, and as such an active long position is no longer justified.

Investment case and model update

P/E ratios

When the initial investment was made by the SMF in 2018, TLS was trading at 9.3 times expected earnings. Today, it is trading at 22.7 times earnings, reflecting a 40% reduction in forward EPS and a 43.5% increase in share price. The current consensus forward P/E and our own forward P/E sit at 40% and 19% higher than TLS's historical average, respectively (see Figure 1). Further, the forward relative P/E versus the market consensus P/E stands at 1.7 times (see Figure 2). The high absolute and relative P/E multiple relative to history highlight the optimism surrounding TLS, and provides an initial suggestion that it may be overvalued.

Figure 1: TLS forward P/E

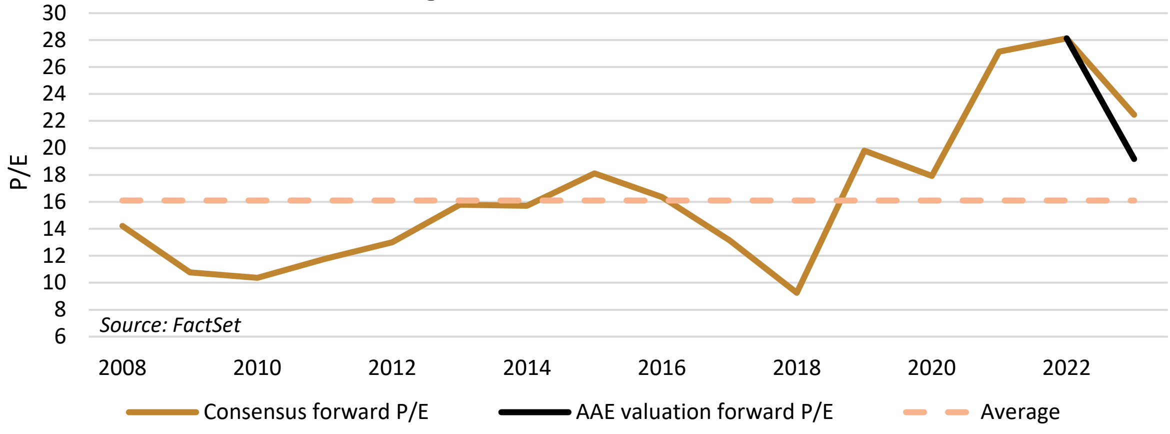
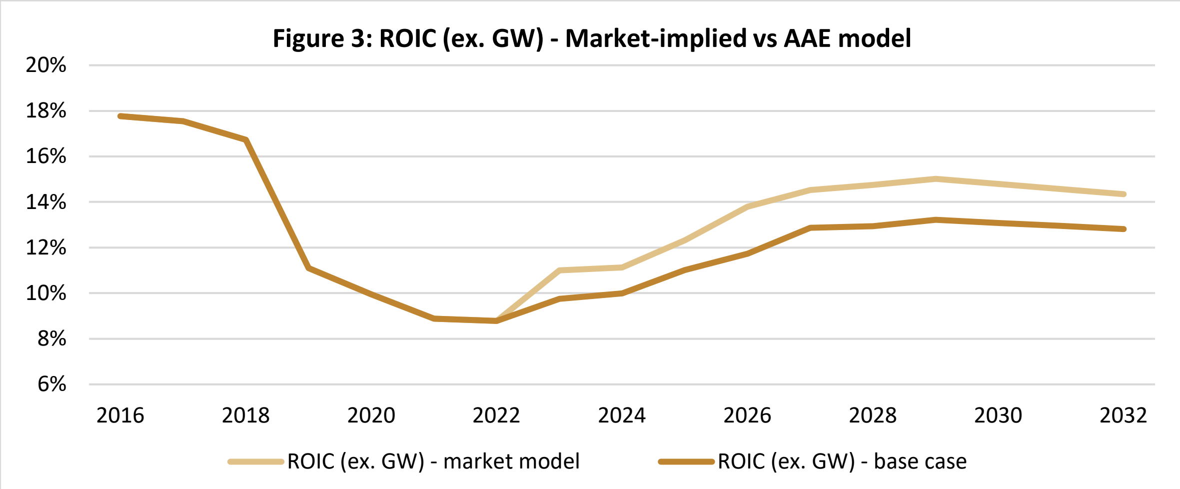


Figure 2: Consensus forward P/E (relative) TLS - ASX All Ordinaries

Implied market expectations

Figure 3 compares the implied market expectations for ROIC excluding goodwill (ex. GW) according to our market model against our own forecasts. The market model estimates that ROIC needs to rebound from below 9% in FY2022 to 14%-15% (i.e. closer to the pre-NBN levels of 17-18%) to justify the current share price. Some improvement in ROIC is probable as much of TLS' recent capital expenditure has been focused on expanding their 5G network, which will generate operating cash flows over the coming years. Since 2016, in excess of $8 billion has been invested into mobile, with much of that aimed at 5G. Going forward, capital spending should diminish and become more focused on maintenance and improvements, which should help to improve ROIC.

Nevertheless, a rebound in ROIC of the magnitude required to justify the current market price seems unlikely given the stronger competitive environment that TLS now faces in both the mobile and fixed segments. The NBN Co's leasing of network services to retail providers has structurally altered the telecommunications industry's competitive environment in fixed line access. Meanwhile, the investment in 5G amounts to TLS keeping pace with competition rather than a likely source of sustainable competitive advantage, such as it enjoyed before 2018 when as a monopoly owner of core industry infrastructure. The implied ROIC also amounts to a significant spread over the cost of capital (our WACC is 6.11%)[1], which seems at odds with TLS operating in largely competitive markets. As such, the ROIC built into the market price seems optimistic.



Business outlook and scenario analysis assumptions

While our sell rating for TLS is primarily based on valuation, it is also underpinned by some deterioration in our outlook for the company's core business. The main developments are:

1. Mobile segment growth is flattening, and seems likely to plateau faster than the market expects.
2. The fixed segment is acting as a drain on earnings with no indications of improvement.
3. Transition to the T25 plan and capacity to continue cost-cutting measures is uncertain. There is a possibility that TLS initiatives might lead to costs being higher than anticipated.

Revenue

The increasingly competitive telecommunications landscape acts to restrain revenue growth expectations for the sector. Research outlined in Deloitte's 2022 Telecom Outlook report indicates that cable and telecommunication companies (telcos) are targeting customers with increasingly similar product offerings centred on broadband and mobile services bundles. As the cost for 5G decreases, this technology can help put telcos on an equal footing to offer competitive broadband internet services using their nationwide mobile infrastructure to areas where fibre is either unavailable or too expensive. Broadening the accessible market for all players could promote heightened pricing competition. Total revenue for the telecommunications industry is forecast to grow at an average growth rate of 0.46% through to 2028 according to IBIS World, representing a 50% decrease on 2021 6-year forecasts (Figure 4).

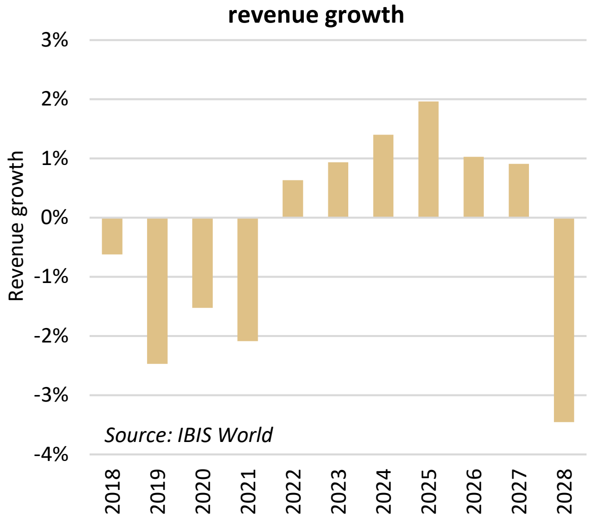
At the industry level, shifting consumer behaviour has the potential to inhibit TLS' ability to grow organically. Improved mobile connection speeds, the optimisation of applications for mobile usage and the transition to larger screens have all contributed to a technological shift from home desktops to smart phones. These factors were evident in a -5.3% change in TLS' fixed segment revenue from FY21 to FY22, whilst bolstering the mobile revenue by 1.7% over the same period. Ongoing improvement of mobile networks should see widespread uptake of mobile technologies, with potential for margin pressure as TLS becomes more reliant on spending on innovation to maintain a competitive edge and sustain premium pricing. These technological changes introduce the possibility of a more competitive and less profitable broadband markets.

[1] For comparison, JP Morgan use a WACC of 6.1%.

Upside to our cautious perspective on mobile could arise from faster-than-anticipated uptake in 5G products and its associated infrastructure. This could compel consumers to purchase more of TLS' premium product line, which relates to TLS being a first mover within this space. Further, hybrid-work models induced through the COVID-19 pandemic continue to display dependency on strong network connections. TLS is projecting their enterprise service line to grow by 2% in FY23.

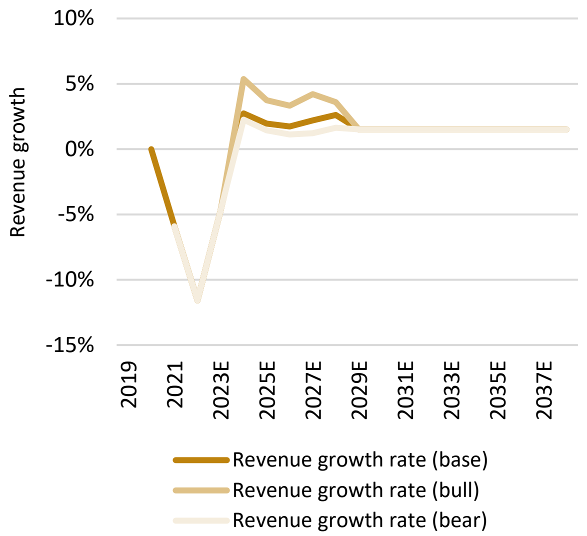
Our bull scenario encapsulates stronger mobile growth, underpinned by the faster 5G uptake and furthering of reliance on mobile connectivity versus fixed networks. The bear case incorporates an erosion of mobile growth due to the impact of competitive pricing, and negative consumer sentiment towards paying a premium for the TLS service. These impacts are applied over the explicit forecast period, with revenue growth kept constant at 1.5% thereafter under all scenarios (see Figure 5).

Figure 4: Telecommunications services revenue growth



Source: IBIS World

Figure 5: Revenue growth



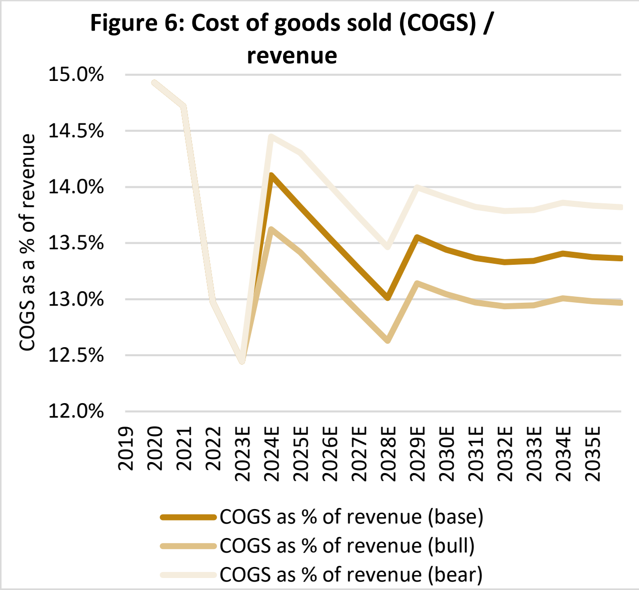
Costs and margins

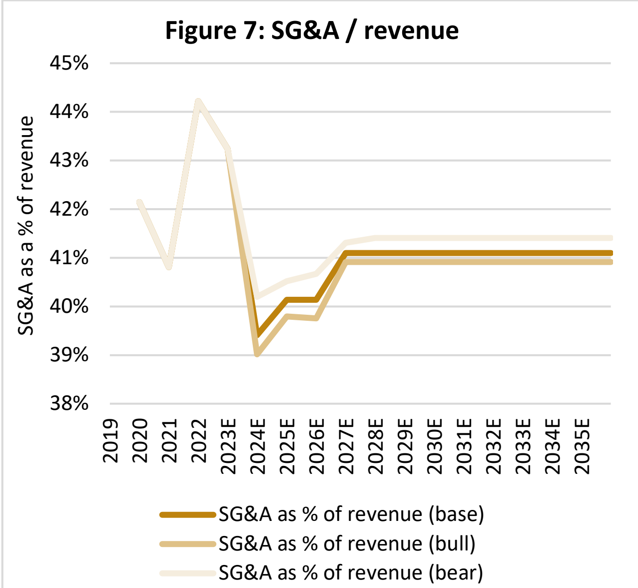
Margins across our scenarios are driven by our assumptions on TLS' ability to concurrently achieve revenue growth while managing costs. TLS' T22 strategy aimed at the simplification of product offerings and significant cost reduction, targeting EBIT margins in line with the long-term average of 14.8% versus 8.5% in FY19. These savings were realised with a $2.7 billion reduction in underlying fixed costs since the announcement of the project in FY16.

TLS has announced its T25 strategy, which aims to improve customer experience, provide leading network and technology solutions, and create sustained growth and value for shareholders. TLS has stated several growth goals, including but not limited to 95% population for coverage for the 5G network by FY25 and expansion of regional coverage. Simultaneously, TLS has forecasted a $500 million net fixed cost-out from FY23 to FY25.

TLS management has targeted "mid-teens" margins for the fixed Consumer and Small Business segment versus reported margins of 1.2% in FY22. TLS' NBN reseller margin of 5% compares with the management target of 8% in FY23 and then "mid-teens" by 2025. Given the increased competition in the NBN reseller market is maintaining pressure on margins and the completion of cost-cutting, the management objectives for margins seem very optimistic. The increasing scarcity of spectrum also exacerbates the risk of margin pressure, as firms may pay increasing premiums to compete to secure additional spectrum to support their services.

Our bull scenario incorporates TLS delivering on its planned cost cuts and achieving its targets for fixed and overall margins. The bear case represents a competitive price squeeze with revenues falling along with a smaller reduction in selling, general and administration (SG&A) expenses in order to resist the erosion of market share. TLS has relatively high fixed costs and hence operating leverage, making its margins sensitive to small changes in SG&A.





Valuation and key diagnostics across scenarios

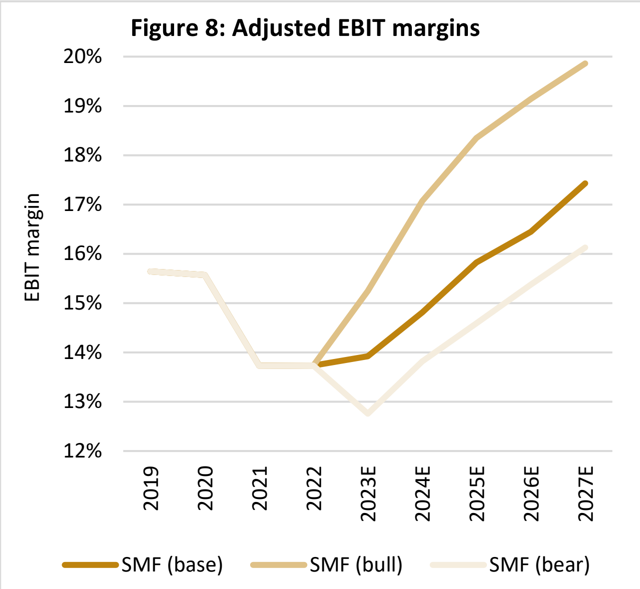
Applying these scenarios to our model delivers valuations that are negatively skewed relative to the current share price, as shown in Table 1. The bull scenario valuation of $3.93 implies a MoS of only 2.12% excluding franking credits (FC) – which represents our estimate of 'fair value' that TLS might trade at in the market – versus the bear scenario valuation of $2.54 and MoS of -34.14%.

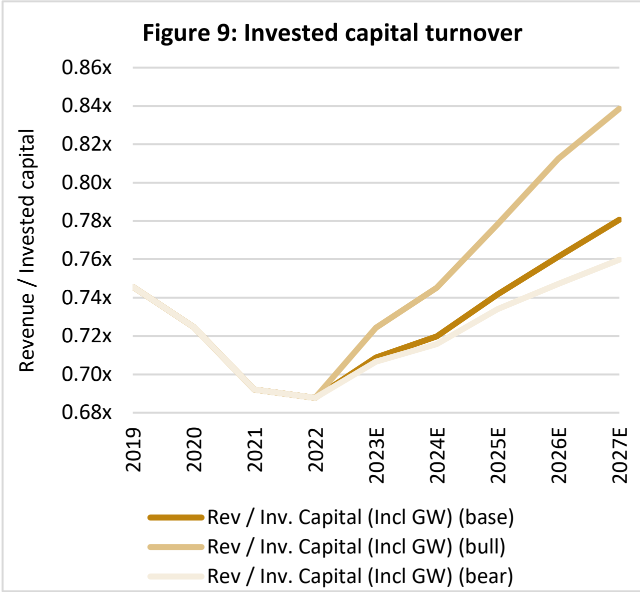
Table 1: Scenario valuations

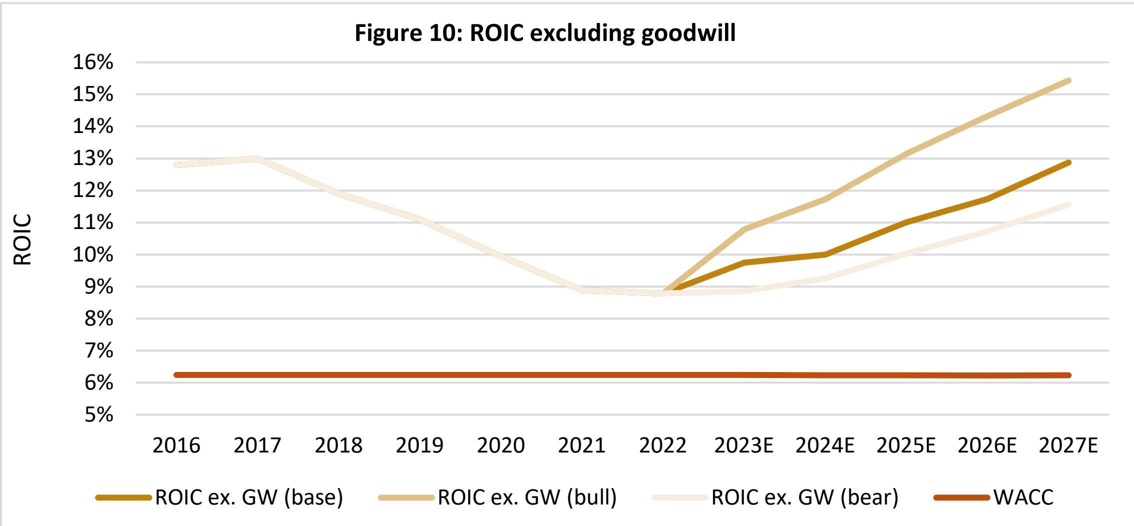
Scenario	Bear	Base	Bull
Share price	$2.54	$3.17	$3.93
MoS ex. FC	-34.14%	-17.74%	2.12%
MoS inc. FC	-10.23%	10.63%	36.61%

Under the bull scenario, TLS grows revenues through their mobile segment by leveraging their pre-existing premium brand to retain and attract customers, whilst limiting costs by restructuring the fixed segment. These factors combine to deliver an EBIT margin of 19.86% over the forecast period, versus 17.43% under the base case (Figure 8). Invested capital turnover is also higher due to improved capital efficiency as the benefits from the T22 simplification materialise (Figure 9). ROIC excluding goodwill averages 13.41%, versus 11.07% under the base case (Figure 10).

The bear scenario captures the operating leverage within the TLS business, with high sensitivity of operating earnings to changes in revenues and costs. EBIT margins decline to an average 14.53% (Figure 8) across the forecast horizon as the company fails to improve operations in the fixed segment and endures a competitive price squeeze, most notably in mobile. TLS also allocates capital to help prevent erosion of market share thus lowering invested capital turnover (Figure 9), depicting a company that requires more capital to achieve similar returns. These effects reduce ROIC to an average of 10.09% versus 11.07% under the base case (Figure 10).



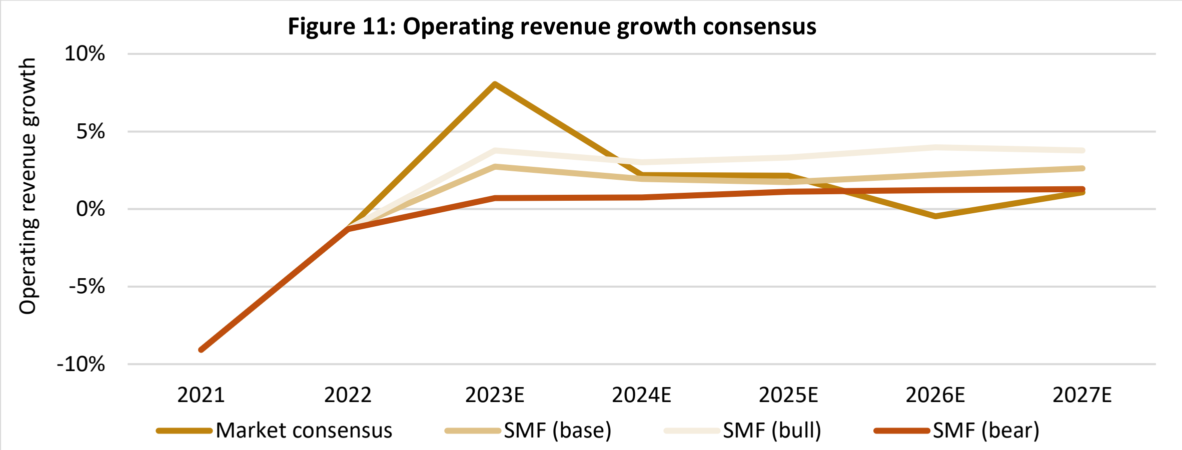




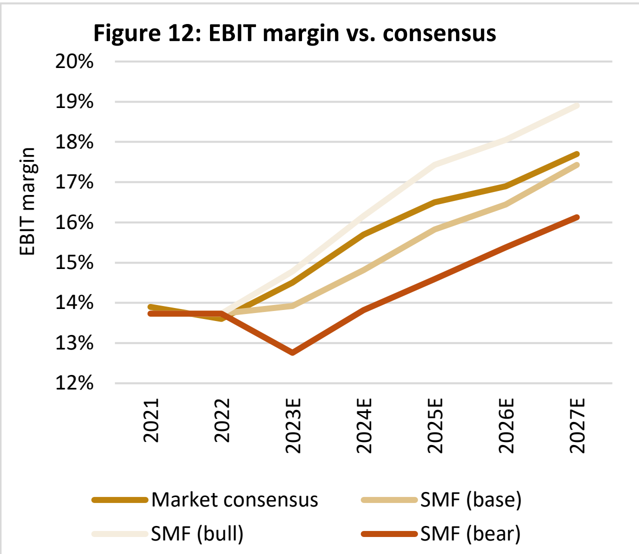
Market consensus

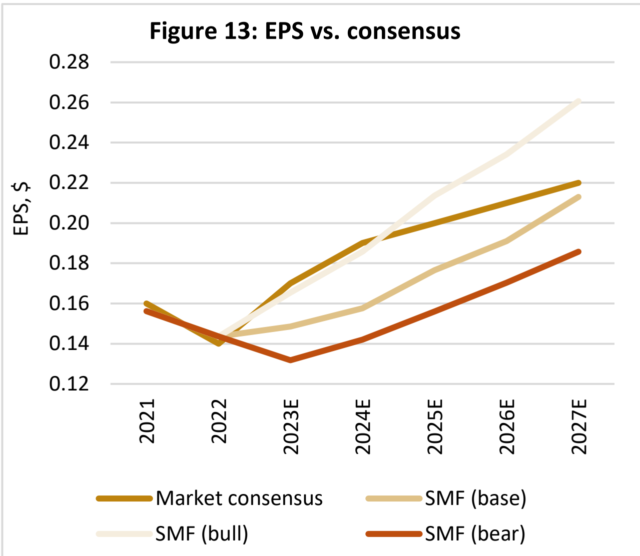
Analysis of market consensus provides further evidence on whether the upside is largely discounted by the market. The brokers covering TLS tend to have a more positive perspective of the company than the SMF, and hence are attaching more weight on the positive signals for TLS and less weight on the risks associated with a high valuation. We attempt to better understand the market consensus and how it differs to our own view by conducting an analysis and comparison of forecasts for revenue growth, EBIT and EPS, recommendations and price targets using data compiled from FactSet. We also consider some key contentions within the market.

Figure 11 indicates that the consensus is expecting a substantial rebound in revenue growth to 8.1% in FY23. This growth is expected to be derived from the mobile segment, which brokers are forecasting to grow at 9.4% in FY23 versus 4.9% in FY22. The market may also now be anticipating substantial customer growth for TLS as a result of the recent Optus security breach. We see a strong possibility that the market is overlooking the more competitive environment in the mobile market since the completion of the NBN. Considering that mobile segment growth has substantially outperformed TLS total growth for the past two financial years, there is a risk that the market for mobile broadband is more mature than the consensus is allowing for. When combined with the challenging economic outlook and the pressure on household budgets, 9.4% mobile revenue growth seems an aggressive expectation. Moreover, the fixed segment continues to depress revenues, with the market forecasting a further 26.2% reduction in fixed revenue in FY23 as demand for fixed connections is replaced by mobile growth and the economic environment challenges businesses.



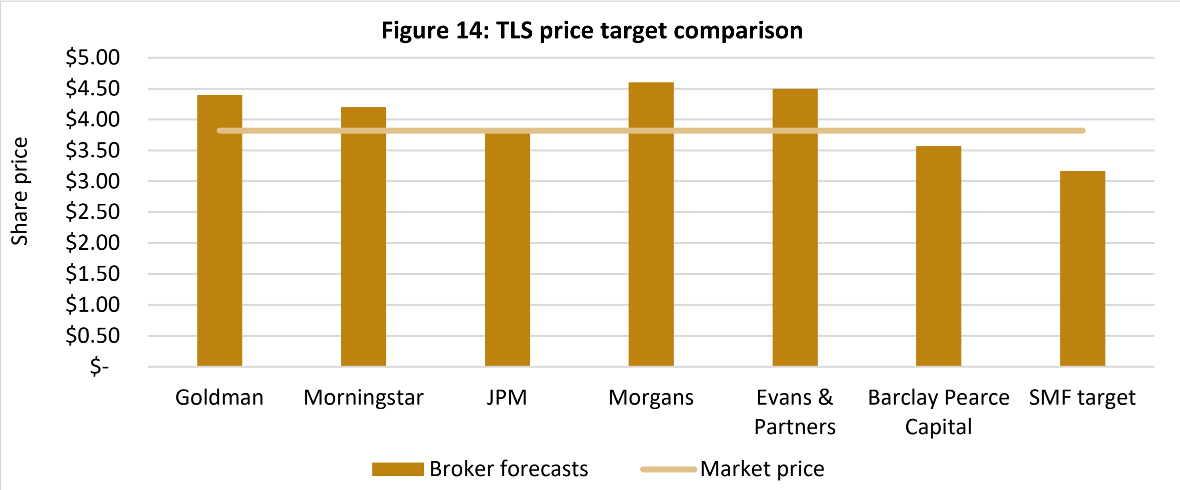
The market consensus for EBIT margins reveals that brokers are expecting TLS to deliver promised cost cuts immediately. Given the current high inflation and TLS's exposure to fixed costs (SG&A is approximately 41% of operating revenue) that are more challenging to pass on to customers, the SMF is more hesitant to incorporate the full effect of the T25 cost cutting in FY23. As such, our EBIT margin improves to only 13.9% in FY23 before picking up to 16.5% in FY24. By 2027, the SMF base case EBIT estimate approaches the market estimate of 17.4%.





The higher revenue growth and EBIT margins expected by the market are reflected in broker estimates for EPS to increase from $0.14 in FY22 to $0.17 in FY23. Forecast EPS for the market consensus exceeds that of the SMF through the forecast period, albeit with the difference narrowing towards 2027 as the EBIT margin forecast by the SMF approach the consensus.

In terms of recommendations, 11 of the 16 analysts covering TLS rate the stock as overweight or buy, four as a hold, and only one as a sell. (The distribution of buy versus sell ratings is approximately in line with the past two years.) Meanwhile, the median price target has increased from $3.43 in September 2020 to $4.46 currently. The clear buy consensus amongst brokers confirms the market's positive view of the company, and is consistent with TLS being optimistically priced.



Broker valuations are supported by investment theses that focus on price increases translating into increasing average revenue per user (ARPU), greater margins from the mobile segment spurred by lower costs due to business simplification, and TLS differentiating its product offerings through the NBN and 5G. The SMF has incorporated these possibilities in the 'best case' bull scenario. The SMF assesses that continuation of a less competitive landscape and a persistent competitive advantage is unlikely given the telecommunications market structure. The likelihood of these events must also be considered against the downside risk related to the possibility that competition could become more intense.

A central plank of the positive consensus is the opportunity in 5G. The TLS 5G network was rolled out in 2019, and provided TLS with a first mover advantage. Since 2019, Optus and Vodafone have also launched a 5G service covering the six largest cities in Australia. It is unclear if TLS can retain a competitive advantage in the 5G market beyond offering superior coverage, with Optus and TPG currently accelerating their rollout. Also, TLS must now invest to compete in the 5G market rather than investing to monopolise the market. This environment does not seem supportive of generating significant excess returns from 5G. Meanwhile, the completion of the NBN rollout means that TLS does not have a dominant last mile network to provide consistent earnings, and must compete for market share against challengers who are willing to accept low margins. The SMF is skeptical of TLS's ability to generate or maintain a competitive advantage whilst reselling a standardised product such as NBN broadband.

For these reasons, we see the odds as skewed towards competition restricting the improvement profitability , and the bull case needed to justify the price as the least likely of our scenarios.

Recommendation summary

The recommendation to sell TLS largely responds to the appreciation of the share price and the associated stretched valuation, rather than any material change in the company operations and earning capacity relative to that on which the position was initially based. We consider it more likely that the expectations built into the TLS share price will be undershot than exceeded. Given this skew towards a negative pricing outcome, we conclude that an active position in TLS within the AAE portfolio is no longer justified.

Appendix

Appendix A: Valuation summary

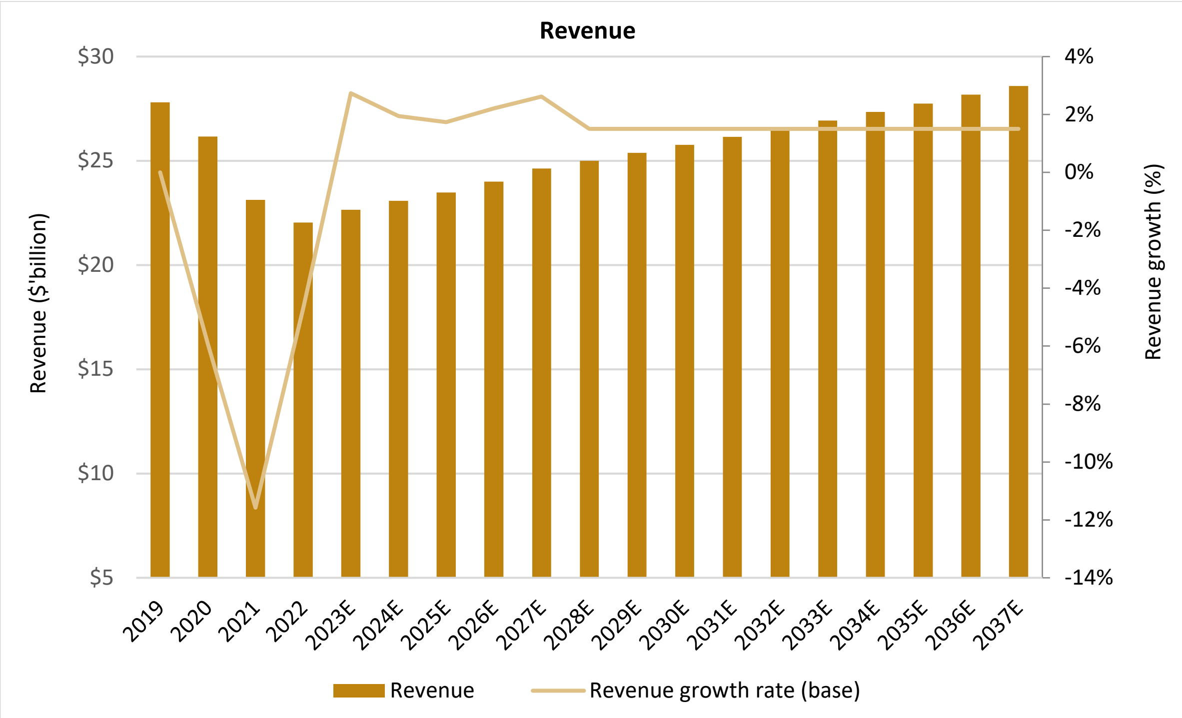
	Bear case	Base case	Bull case
Share price (30/09/22)	$3.85	$3.85	$3.85

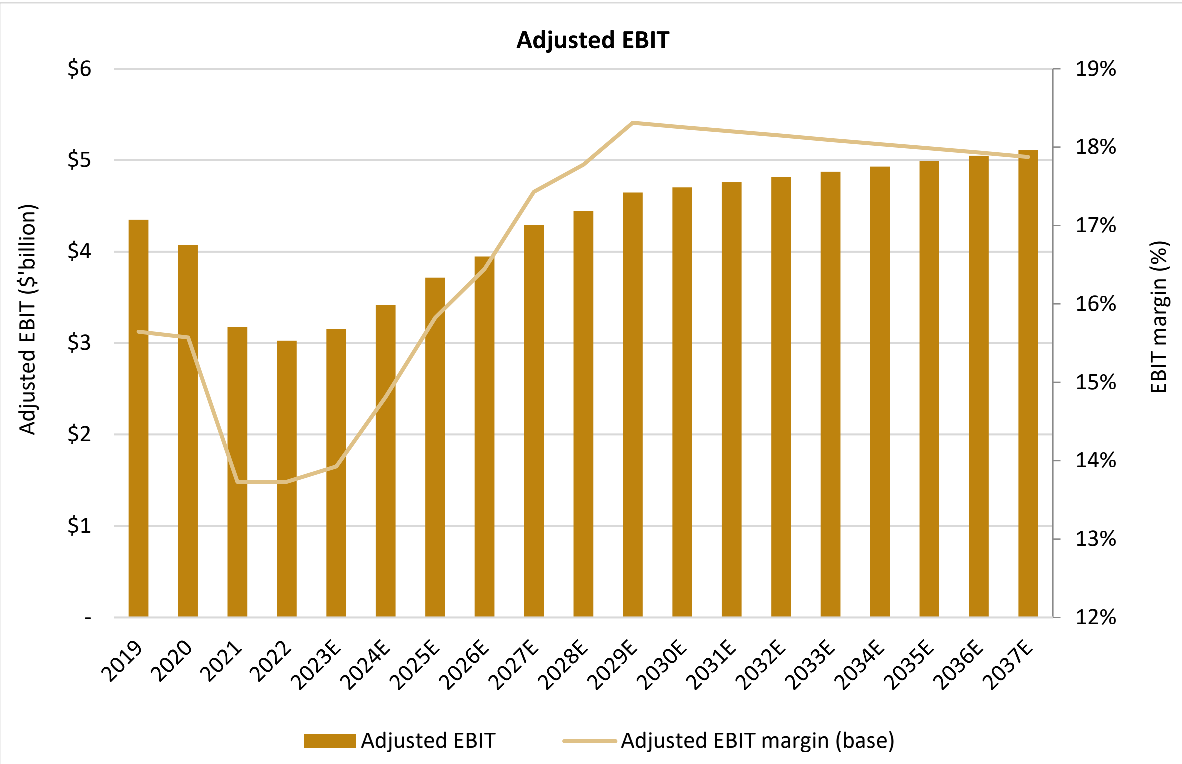
Valuation, ex. FC	$2.54	$3.17	$3.93
Valuation, inc. FC	$3.46	$4.26	$5.26
Margin of safety, ex. FC	**-34.14%**	**-17.74%**	**2.12%**
Margin of safety, inc. FC	-10.23%	10.63%	36.61%
Required return on equity	6.75%	6.75%	6.75%
Cost of debt (after tax)	4.34%	4.34%	4.34%
WACC	6.11%	6.11%	6.11%
Target equity ratio (Equity / IC)	74%	74%	74%

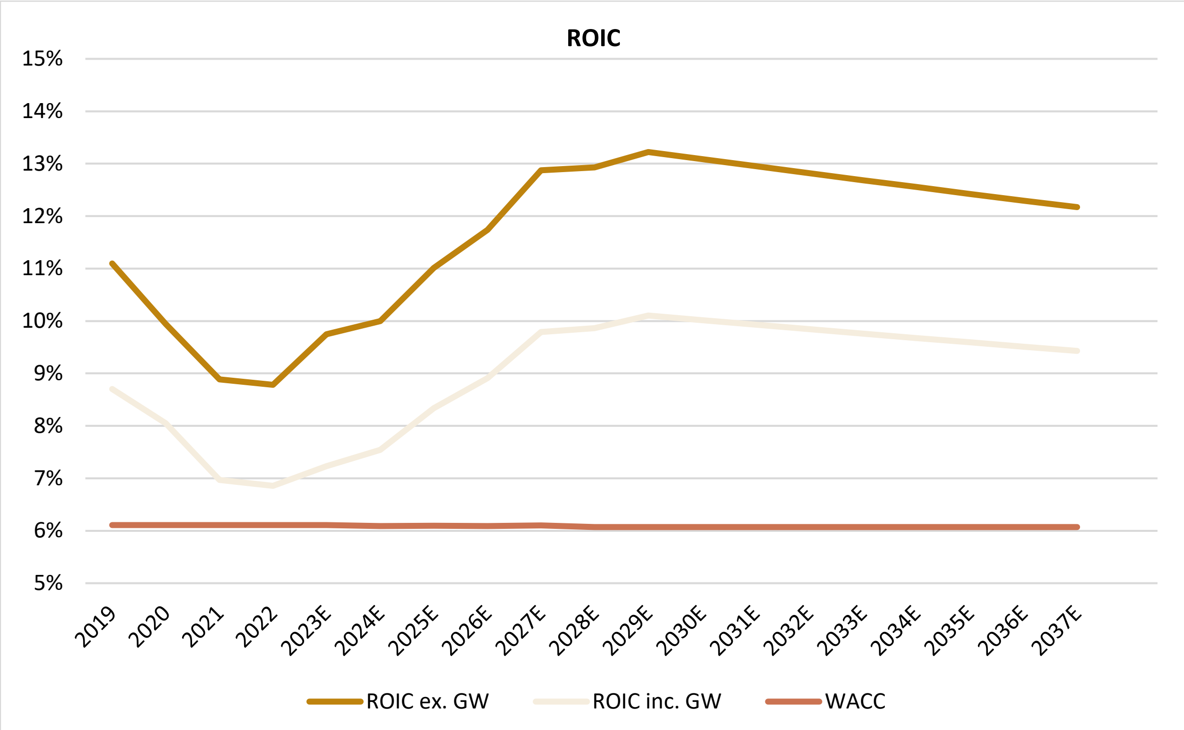
Appendix B: Key financial summary

Financial year ($million	2019(A)	2020(A)	2021(A)	2022(A)	2023(E)	2024(E)	2025(E)
Total revenue	27,807	26,161	23,132	22,045	22,648	23,088	23,488
Revenue growth	-3.59%	-5.92%	-11.58%	-4.70%	2.73%	1.95%	1.73%
Adjusted EBIT	4,350	4,074	3,176	3,027	3,154	3,420	3,717
Adjusted EBIT margins	15.65%	15.57%	13.73%	13.73%	13.93%	14.81%	15.82%
NOPLAT	3,195	3,048	2,393	2,229	2,286	2,437	2,656
NOPLAT margin	11.49%	11.65%	10.35%	10.11%	10.09%	10.56%	11.31%
Invested capital (ex. goodwill)	30,651	26,927	25,376	23,448	24,383	24,123	23,898
Invested capital (inc. goodwill)	37,861	34,339	32,507	31,603	32,302	31,857	31,487
ROIC (ex. goodwill)	11.10%	9.94%	8.89%	8.78%	9.75%	10.00%	11.01%
ROIC (inc. goodwill)	8.70%	8.05%	6.97%	6.86%	7.23%	7.55%	8.34%
Free cash flow	2,047	6,570	4,226	3,133	1,586	2,882	3,026
IC turnover (ex. goodwill)	0.94x	0.91x	0.88x	0.90x	0.95x	0.95x	0.98x
Financial year ($ million)	**2026(E)**	**2027(E)**	**2028(E)**	**2029(E)**	**2030(E)**	**2031(E)**	**2032(E)**
Total revenue	24,007	24,635	24,654	24,808	24,935	25,063	25,193
Revenue growth	2.21%	2.62%	0.08%	0.63%	0.51%	0.51%	0.52%
Adjusted EBIT	3,948	4,294	4,445	4,647	4,703	4,759	4,816
Adjusted EBIT margins	16.45%	17.43%	17.78%	18.31%	18.26%	18.20%	18.15%
NOPLAT	2,805	3,091	3,112	3,253	3,292	3,331	3,371
NOPLAT margin	11.69%	12.55%	12.44%	12.82%	12.78%	12.74%	12.70%
Invested capital (ex. goodwill)	24,006	24,062	24,603	25,157	25,723	26,301	26,893
Invested capital (inc. goodwill)	31,572	31,541	32,195	32,862	33,544	34,240	34,951
ROIC (ex. goodwill)	11.74%	12.88%	12.93%	13.22%	13.09%	12.95%	12.82%
ROIC (inc. goodwill)	8.91%	9.79%	9.87%	10.10%	10.02%	9.93%	9.85%
Free cash flow	2,720	3,122	2,458	2,586	2,610	2,635	3,660
IC turnover (ex. goodwill)	1.00x	1.03x	1.03x	1.02x	1.01x	1.01x	1.00x

Appendix C: Key financial drivers






ROIC
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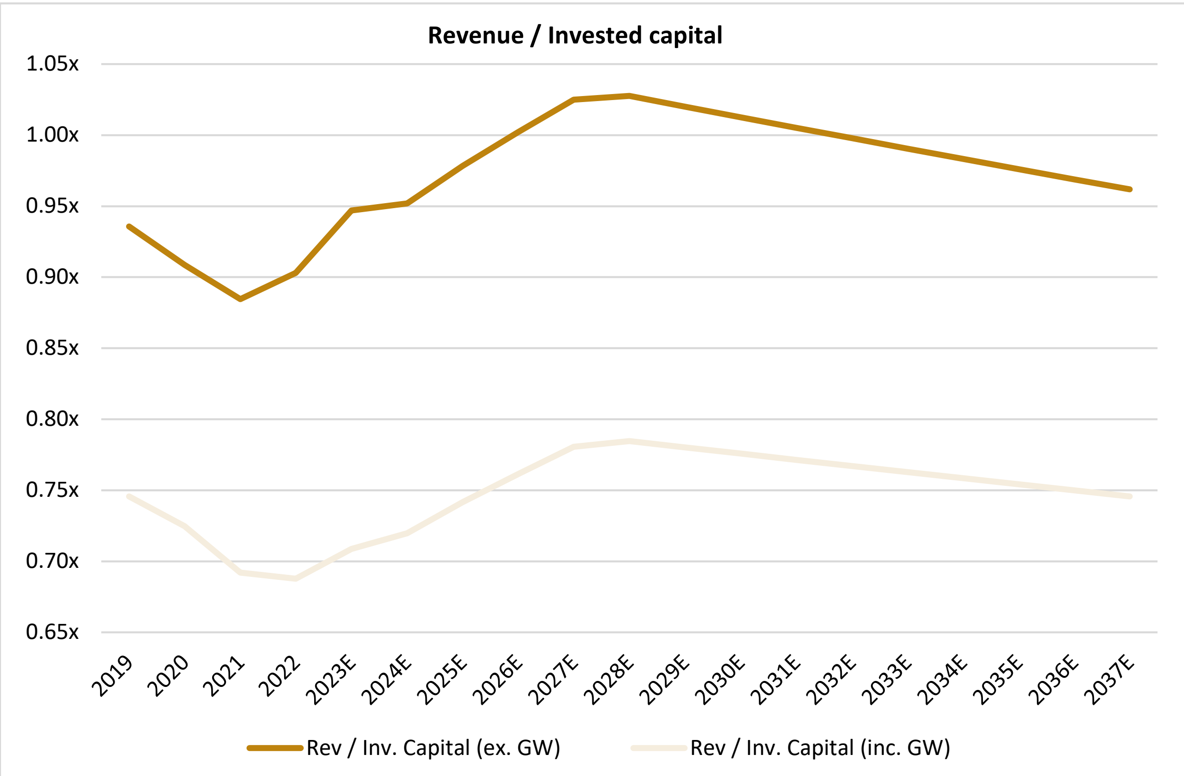
ROIC ex. GW
ROIC inc. GW
WACC


Revenue / Invested capital
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0.75x
0.70x
0.65x
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2033E
2034E
2035E
2036E
2037E
Rev / Inv. Capital (ex. GW)
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