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HD **Cashed-up Telstra looks to make next M&A move**

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Telcos Thodey predicts "radically different Telstra by 2020 as it hunts growth.

Back in the day, any Telstra executive wishing to sell one of the **company**'s divisions would be summoned up to the chief financial officer's office on the gleaming level 40 executive floor of Telstra's Exhibition Street head office in Melbourne for "the chat".

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One executive who was subject to such grillings recalls that John Stanhope, who reigned under three CEOs until 2011, would, without fail, ask two questions.

"What would you do with the money?" And: "How will you replace the revenue and earnings we will lose from the businesses you want to sell?"

If they didn't have a convincing answer, he would not let them sell it.

Telstra's army of 1.4 **million** shareholders are asking the same question of CEO David Thodey and CFO Andy Penn this weekend after a flurry of divestments that culminated in the historic $454 **million sale** of a 70 per cent **stake** in its directories business Sensis, which publishes the Yellow and White Pages as well as The Trading Post.

Just last month Telstra announced the **sale** of its **Hong Kong**-based mobiles business CSL to HKT Limited for US$2.43 **billion**. By June Telstra should have up to $5.5 **billion** of net cash in the bank, plus a liquid (sellable) $US1.9 **billion stake** in newly-listed **Chinese** internet **group** Autohome.

It is a very nice problem to have. And the share price, at $5.24, is close to its highest point since February 2002.

But with the looming loss of its most profitable business, the old fashioned **copper** telephone network, to the national broadband network in return for $11.2 **billion**, the long-term future of Telstra is up for grabs.

Thodey knows it. Speaking to the Weekend AFR from San Francisco, he was candid when asked what Telstra will look like come 2020.

"It must look radically different because we will no longer have a **copper** network and therefore we have to find new areas of growth be it organic or by acquisitions," he says.

Asked whether Telstra, which owns 50 per cent of pay television operator Foxtel, would be so radical as to make a bid for a **commercial** broadcaster such as Ten Network Holdings, Mr Thodey said: "The [competition] regulator has been very clear about Telstra's opportunity to invest in free to air television. Unless the regulator changed their mind or the minister changed policy we could not acquire a television network."

But Telstra will: "Continue to watch the evolving digital media industry closely."

Even though the telecommunications giant has just sold CSL, due to "unique" circumstances in the Hong Kong market, Thodey says Telstra would be interested in buying an Asian mobile phone business "if we could ever find one at the right price".

But the biggest focus for Telstra's 12-strong in-house mergers and acquisitions team, led by Neil Louis, is on cloud computing and network application services in Asia, where it hopes to tap into burgeoning demand from business. Thodey, a former IBM executive , is very familiar with the business of helping corporates and governments manage their IT and telecommunications infrastructure.

"Our Asia strategy is consistent," he said. "We've been in the region for 70 years and we've signalled significant expansion plans around our enterprise services division and we are building out cloud platforms in Singapore, Honk Kong and other locations and we continue to invest."

The appointment in October of Brendon Riley as group executive of a new $5 billion global enterprise and services division was, according to Thodey, "very significant".

But some analysts note not only the disastrous foreign adventures of Australian giants like NAB in the UK but also that some traditional telcos have moved deep into the IT world before with disastrous results. Britain's BT Group suffered a slew of profit warnings after its Global Services Division overstretched itself and wrote dirt cheap contracts with customers in a push to win business in this highly competitive space.

Thodey insisted Telstra would not suffer the same fate "because we watched what BT did".

"They grew too quickly and by an enormous number of acquisitions."

Some insiders say Telstra executives have in the past struggled to convince its highly conservative board to back an aggressive Asian strategy.

One former executive says that conservatism would often manifest in the run up to results and investor days, when managers would drop their prior openness to considering spending, either on increased cash returns or acquisitions, and would play safe.

Mr Stanhope preferred one-off returns to interim or full-year dividends because they did not leave the company committed to a higher payout.

Thodey says the board has a long-term intention to increase dividends but he was careful to manage expectations tightly this weekend.

"We don't have the cash today. It's very important to note that both transactions (CSL and Sensis) are subject to regulatory approval and we are by nature a conservative company."

He also points out that the company "very intentionally" published its capital management policy" to show the market the "rigorous discipline" it goes employs when deciding how to deploy excess cash.

Telstra's problem is that it is competing for assets with nimble global giants like Google, which this week bought Smart Thermostat maker Nest for US$3.2 billion.

Yet some investors are content for the company to stick to its knitting. It has to negotiate with the Abbott government which wants to tweak its $11.2 billion deal to provide ducts, pipes and copper lines to the NBN. It is likely to save any cash returns until those negotiations are concluded – which could be some time, based on the tortured talks with the previous government. After that, Telstra could pay a special dividend – but it would not have enough franking credits to frank it and the share price is too high to justify a buyback.

Tyndall Investment Management portfolio manager Michael Maughan says Telstra will be forced to adapt to the changing environment but said staying the course and handing cash back to shareholders was the best way forward.

"Telstra needs to be ready for a more competitive environment by having better systems and customer service as well as the best brand and offering," he says.

"They'll still own and control some of the fixed assets as well as the mobile network so it's not going to be an asset-light business.

"[No one] has come up with a great idea that Telstra should go and spend [the free cash] on and they haven't flagged anything."

Telstra could speed up its existing strategy of building assets in Asia by buying companies they can tack onto existing businesses. "But that's very different to spending $10 billion to buy a telco in another region," Maughan added. "Telstra could change its mind and completely change the business but I don't forsee that."

He expects Telstra to wait for payments from the NBN deal to come through with franking credits before handing funds back to shareholders.

"The reason why there's an expectation Telstra could spend the excess capital now is because it doesn't have franking credits to give back to shareholders in a tax-effective way," Maughan says.

Other observers say Telstra is often slow to act on M&A opportunities as exemplified by its long-delayed decision to sell Sensis.

They claim it is symptomatic of Thodey's indecisiveness, a long-standing accusation, although Thodey became CEO in 2009, after the board rejected calls to sell Sensis in 2006 . But some of Thoddey's M&A calls have undoubtedly been questionable.

Telstra crowed how it had made an attractive profit in 2010 when he decided to sell its 50.6 per cent stake in SouFun, the No. 1 real estate site in China.

But whereas that deal valued SouFun at $US850 million, the company now has a market cap of some $US7.17 billion.

After a stuttering start that began with a series of profit and guidance warnings, Thodey has achieved much in his five years as Telstra CEO.

Chief among these is the historic accord with the former Labor government over the NBN, which delivered handsome compensation for the loss of its fixed line monopoly.

He has shrunk the company's bloated workforce by more than 8,000 with the help of productivity enforcer, business support and improvement boss Robert Nason,

But critics says Thodey has also been lucky.

Impressive mobile growth has been largely at the expense of troubled rival Vodafone. And while analysts expect the telecommunications market to grow just ahead of GDP, mobile will no longer enjoy the stunning growth it once had.

The share price recovery and rise has also been fuelled by his inheritance of the company's 28 cents dividend and investors post-GFC passion for safety and yield.

But unless it invests in new services, Telstra risks becoming a shrunken hulk offering no growth.

That would be satisfactory outcome for some investors but, shorn of its precious network, the dividend will be much harder to sustain long-term.

Arnhem Investment Management partner Theo Maas said that while Mr Thodey had done an excellent job during his time as CEO, the company would inevitably get smaller over the long term.

"His role was very much to get the relationship with the government back on track and to get the NBN relationship going again," he said.

"Is that the same kind of leadership you'd like for the long-term strategic future [for Telstra]? It's probably unlikely in my view."

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