Telstra (ASX:TLS) Equity research report

Table of Contents

Business strategy:

Economic Analysis

The current economic environment is critical to evaluate as the impacts of key events and industry factors will affect the operations and growth opportunities of Telstra. With Telstra's services mainly competing in the mobile, broadband and fixed line telecommunication services, this sector is a large industry in Australia that contributes significantly to the economic output and growth of the nation, justified by the government funded program, NBN, where they sought to improve the national telecommunication infrastructure and overall connectivity of the country.

With key competitors including Optus, TPG and Vocus Group, the concentrated market share of large key players showcase the level of fierce competition held by a significant few. Past earnings growth figures in the Australian telecommunications sector reveal that the earnings for Australian companies in this industry have grown 9.1% in the last three years, with a revenue growth sitting at 6.1% per year. Other key economic factors affecting Telstra include customer behaviour and with 91% of active internet users as a total share of the Australian population, the current Australian telecommunications industry generates a gross value of $24.84 billion AUD. This factor presents a strong and ongoing consumer need for this type of service and can predict a reasonably strong long-term viability of Telstra being in this market.

Additionally, it is important to note the ever-evolving nature and adoption of the Internet of Things (IoT) and smart devices particularly as a result of the covid pandemic and need for connection during a time of isolation. The IoT and increasing reliance on smart devices has ensured costs are optimised through the availability and commonality of products and services which are driving market growth with the forecasted earnings to improve by 4.5% over the next few years in the telecommunication services industry in Australia.

Finally, a driving factor in the economic growth of this industry are the consequences of the COVID pandemic over the last three years. The importance and utter reliance of offline connection and strong telecommunication infrastructure as people worked from home was an essential service and resulted in a strong spike in data traffic. This shift in disrupting traditional business models has revealed a long term and ongoing trend, changing the working landscape for many industries and forcing them to adapt to the online world to retain employees and stay competitive which in turn has generated substantial investment in the telecommunications industry, again adding to the need for Telstra's service offering.

Porter's Five Forces

To further reveal the positioning of Telstra in the wider market, the use of Porter's Five Forces model will be presented below to take a closer look at the overall profitability and viability of the industry.

Rivalry Amongst existing firms (HIGH)

Key competitors including larger telecommunication giants TPG, Vocus Group and Optus, who provide relatively similar offerings, contribute to the high degree of competitiveness and rivalry within the Australian telecommunications sector. With similar connectivity of different network providers in major cities, the high competition in the market lends a risk to Telstra as the focus on a cost leadership strategy and overall simplification of products as per their T22 and T25 business strategy, may lead consumers to look for services elsewhere in terms of differentiation and amore personalised and custom offering. Additionally, new alliances between top-tier service providers including TPGs acquisition of iiNet has created some increased competition for Telstra and will further place sustained pressure of it's current market share (43.3%). Further adding to the high competition ae the high exit barriers due to the specialised equipment and capital investments required to start and sustain a telecommunications product/service

Threat of new entrants (LOW)

The threat of new entrants for the industry are low as the barriers of entry are reasonably high due to the large capital investment to create a sustainable service and the need for a large network. Akin to this, gaining a licence to enter and operate this market is difficult and can disencourage new entrants due to lengthy and costly processes. The telecommunications market in Australia demands substantial investments in maintenance, updating, and extension of networks and services, yet with low barriers of entry, this can also put pressure on Telstra to make sure they are constantly investing in technological advancements to retain their market share and advance their services to fit consumer needs. Furthermore, the sound threat of mobile virtual network operators (MVNO) essentially means that a large number of competitors who do not own or build their own network but act as mobile virtual network operator (MVNO), through obtaining bulk access to network services at wholesale rates and then set retail prices independently. A good example was Amaysim, which used the Optus network and had a large market share before being acquired by Optus. On the one hand, it is an opportunity for Telstra to sell their network, on the other hand the margins associated with these contracts are typically lower and existing customers might be acquired by these new competitors.

Threat of substitute products (LOW)

Whilst there is no clear threat of substitute products, there are alternative methods of communication such as traditional telecommunication methods such as messaging apps, yet they require internet connection which is ultimately provided by key players such as Telstra. It is crucial to be aware that if there are new, advanced ways of communication being innovated, Telstra needs to ensure they are adapting their services to stay up to date with changes in the environment and as the internet will always be a necessity, the infrastructure will always be somewhat valuable. Starlink, satellite internet provider, may be seen as a substitute product, with its main advantage over conventional satellite internet suppliers being that its satellites orbit Earth at a much lower altitude which able it to deliver speedy internet with low latency. Yet, it is noticeably more expensive than the NBN broadband services Telstra provides which ensures the competitive nature of Telstra in the market.

Bargaining power of buyers (HIGH)

The bargaining power of buyers is high in this industry due to the similar nature of offerings from all telecommunication companies and the similar network providers in all of the major cities being of similar strength. In addition to this factor, the price sensitivity is high as products are similar and price comparison is easily achievable which again creates power for the buyers. This leads to price increases being hard to justify unless there is a key point of differentiation and the low switching costs as a result are an incentive for telecommunication firms to engage in price competition and price wars. Overall, the bargaining power of buyers is confirmed which increases the competition for market share by the large telecommunication providers with a key focus on meeting consumer demand.

Bargaining power of suppliers (MODERATE)

The bargaining power of suppliers within this industry is moderate mainly due to highly accessible local and international manufacturers in the market With relatively low switching costs from one supplier to the other further limits supplier power which leads to Telstra gaining a competitive advantage. Although suppliers are integral for the supply of mobile handsets, fiber-optic cables, billing software, and broadband, human resources such as engineers and specialists equilibrate the bargaining power of suppliers. Telstra's procurement team source products and services from small companies in Australia to large corporations overseas, which indicates the availability of inputs which the company can leverage to their advantage due to an array of options.

Competitive Strategy Analysis

Telstra's overall business strategy and position relative to the Australian telecommunication s market can be explored through the above market analysis but further understood through an internal analysis of its core strategy and objectives. With Telstra currently owning 43.3% of the market share in Australia and having the largest mobile network in the country, it is clear that its portfolio is seeing growth due to its key T22 and now T25 strategy it has set out.

The overall strategy of Telstra can be deduced as a broad cost leadership approach as revealed by the key pillars set out in both the T22 and T25 strategies. In 2018, Telstra announced its T22 strategy for the next three years with key priorities including the simplification of product offerings detailed through contracts providing more flexibility to meet consumer needs, cost reductions which saw operating expenses decreased by 20.5% from 2019 to 2022 and further achieved through the sale of non-core assets. Other key priorities included extending its leadership in 5G network infrastructure, increasing productivity leading to layoffs and further completing a digitisation program to transform customer experiences. As evidenced, over the past 3 years, Telstra has been working towards advancing its network capabilities and the evolution of this strategy can be summarised below through some key metrics.

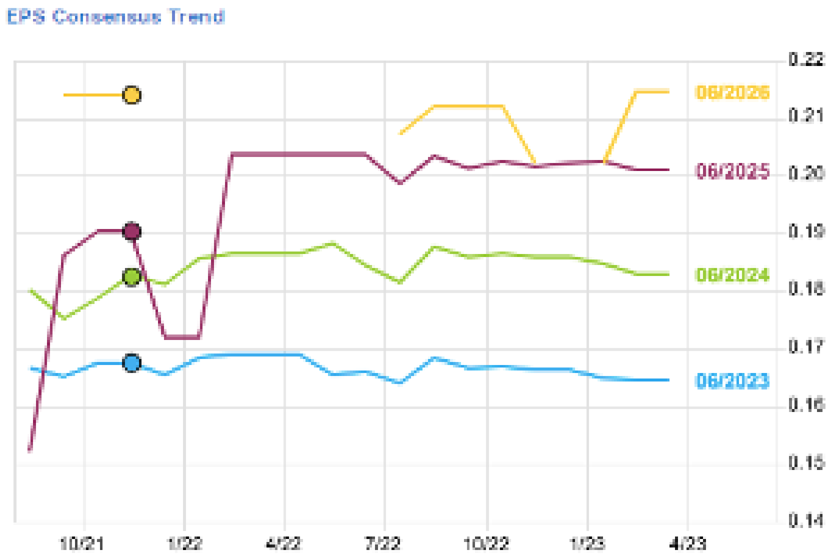
<u>Progression of achieved strategy</u>

FY2020	FY2021	FY2022
NPS declined -2	NPS improved +9 in the last 12 months	NPS improved +5 last 12 months
$615m or 9.2% underlying fixed cost reduction in FY20	$90m or 8.1% underlying fixed cost reduction in FY21	>$2.7 billion fixed cost reduction since FY16
+620k NBN connections with 46% estimated market share as at end of FY20	+264k NBN connections with 45% estimated market share as at end of FY21	National lead in combined 4G/5G speeds.
#1 in major mobile network leadership surveys such T22 launch	Network leadership- 75% of population covered- Australia's largest 5G network	Australia's largest 5G network with 80% of population covered

To further understand Telstra's projected strategy for the next three years, the T25 strategy can simply be summarised into four key pillars:

1. Provide Exceptional Customer Experience	**2. Providing leading network and technological solutions**	**3. Created sustained growth and value for shareholders**	**4. Improved employee satisfaction. Focus on leveraging capabilities built in T22.**

To explain the trajectory for the company's competitive strategy, the aim of increasing its network leadership and regional expansion coverage is front of mind and the growth and value it aims to achieve through improving its underlying EBITDA and maintaining its cost disciplines is crucial to its long term corporate strategy. Further, a commitment to ESG and sustainability is presented as it aims to reduce its company wide absolute emissions. Finally, the aim of providing more advanced consumer offerings exemplified through its Telstra Health offering and partnership with Quantium, showcases the company's strategy in aligning itself with like minded and strong brands to provide amenity and added value to its consumers. Based on the competitive strategy outlined above, see below the expected EPS trend for the following three years which shows a projected indication of the profit sustainability of Telstra.



(Factset, 2023)

Accounting Analysis:

Key Accounting Policies

Telstra's accounting policies are subject to various judgements which require managerial discretion to formulate the company's financial reports; especially in key areas such as revenue recognition and capitalization & depreciation of assets. These aspects of the financial report have a significant possibility of distorting profits and therefore altering the underlying business reality. There is vital importance to having robust internal controls to ensure that management makes sound judgements in these areas. This part of the report will provide an insight into the judgements required by management as well as how Telstra's auditing company, Ernst and Young (EY), audited these aspects of the annual report.

Revenue recognition

Telstra exercises a significant amount of judgement in recognizing their revenue regarding new products and plans, large Network Application Services (NAS) contracts and NBN revenue which is revised under the Definitive Agreements (DAs). Accounting for the accuracy in these aspects of revenue is an industry risk due to the complicated nature of the product and service offerings and the distribution channels of these products and services. Also, the complexity of the billing system and its reliance on automated processes combined with the frequent price changes that occur throughout the year increase the difficulty of accurately recognising revenue for these products.

EY assessed the competence of Telstra’s accounting policies by evaluating its compliance with the specifications of revenue recognition required by the Australian Accounting Standards. They collated and analysed a sample of transactions including customer contracts, contractual agreements, service detail records, evidence of customer payments and other documents for the relevant sales transactions of these products and services. EY also examined the design and operating efficiencies of controls that collect and measure this data by inspecting the relevant IT systems and the timing of these transactions.

They also investigated the suitability of the assumptions and approximations utilised in accounting for the revenues from NAS contracts. These contracts are considered high risk due to the nature of their delivery and size. EY examined the contract life cycle and analysed the contractual terms, they further acquired evidence of customer acceptance and delivery which assisted them in testing the efficiency of controls put in place to recognize revenue.

<u>Depreciation and impairment of assets</u>

Telstra’s accounting policies also require significant managerial discretion regarding the determination of useful lives and carrying values of assets such as property, plant and equipment. Management is required to identify impairment indicators and estimate the recoverable value of assets. These values determine the calculation of depreciation and impairment expenses which in turn affect the company’s reported profit.

EY analysed the implementation of Telstra’s annual life review which discusses assumptions and appropriations made on aspects concerned with the calculation of depreciation and impairment. They compared the useful lives that were assigned to assets with industry norms and whether any changes in technology or market conditions justified changes in the useful life. They also investigated judgements made concerning the impairment of software intangible assets, specifically related to the changes that resulted from the T22 strategy.

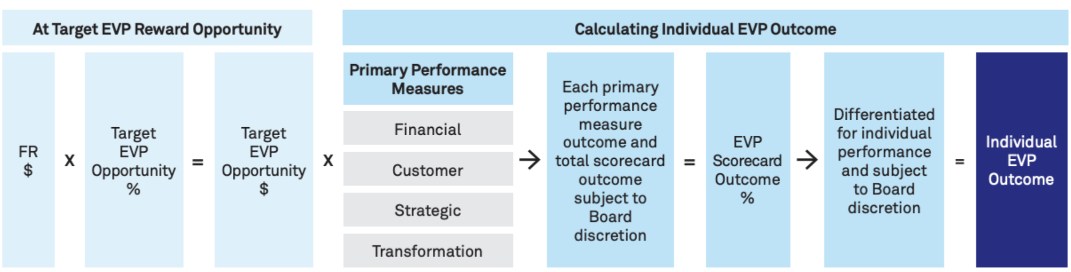
<u>Capitalisation of assets</u>

Another matter that requires managerial discretion is the decision of capitalising or expensing costs. This determines whether an asset is expensed in the income statement or recorded as an asset in the balance sheet and therefore the policies regarding capitalisation are vital to the company's reported profitability.

EY examined the controls that are concerned with the acquisition and disposal of assets whether the capitalisation policies were in line with relevant accounting standards. They selected a sample of capitalised costs and inspect supporting documentation to evaluate if capitalising the asset was the appropriate decision.

Incentives for manipulation

Telstra's remuneration report indicates that they use a combination of short-term and long-term incentives combined with a range of primary performance measures to calculate the Employee Value Proposition (EVP) of their senior executive directors. The primary performance measures consist of financial, customer, strategic and transformation metrics that are all subject to board discretion. The fixed remuneration is made up of their base salary, superannuation and non-monetary benefits. On top of this they receive short term incentives which are made up of financial measures such as group performance, and non-financial measures such as strategic targets and individual performance. They also receive long term benefits which are based on their achievements on long term performance periods.



(Telstra Annual Report, 2022)

The report suggests that the senior executives compensation is not directly tied to any financial performance, and it includes a mix of short-term, long-term and financial performance. The structure put in place assists in minimising the incentive for senior executives to manipulate financial statements for personal financial gain.

Potential Red Flags

EBITDA and Non-GAAP measures

The consistent use of EBITDA as a preferred metric to measure Telstra's performance is apparent and concerning as this measurement does not fully reflect the risks that are associated with the increases in debt within the company. Stated EBITDA figures showed a large climb of 5.1% to $3.5 billion in 2022 which showcases a relatively strong period of growth but this again this metric removes the real expenses for the company which may mislead the profitability figures which is an issue for capital-intensive companies such as Telstra. To expand upon this, EBITDA as a non-GAAP measure shows a distortion of cash flows and may obscure warning signs such as high debt levels within the company which are being fabricated to ensure investors of the growth occurring at a surface level. Hence, this measure is subject to manipulation as there are no rules given within the AASB and there is flexibility to distort this from the discretion of managers. Furthermore, non-GAAP measures used as metrics to showcase financial objectives for FY22 were given priority as the CEO weighting free cash flow as 17% of the weighted result in FY22. This may mislead stakeholders of Telstra as investors may be unaware of the acquisition of MedicalDirector which contributed to a $340 million cash outflow as well as the acquisition of Fone Zone which contributed $375 million in cash outflow (Telstra 2022). Thus, the reported cash flow was $3,961 million and the acquisition activity would be a material difference in free cash flow.

Legal re-organisation

Another potential red flag to discuss within Telstra's accounting quality is the legal re-organisation that has been carried out summarised through the creation of subsidiaries under the New Telstra Corp; ServeCo, InfraCo Fixed, Ampitel, and Telstra International. The company has previously stated that this will "not, in itself, result in any immediate change to the underlying assets and business activity of the Telstra Group as a whole" (Telstra 2022), the company fails to explain the long term effects on assets for subsidiary creation, and therefore it may prevent quality and transparent analysis from being conducted due to a lack of explanation behind the logic of the restructure and provide opportunity for Telstra to manipulate information. Further deduced from this situation, one might conclude it as a material risk, as the establishment of a new holding company and the transfer of assets to ServeCo scheme has not been announced for shareholder approval.

Financial Analysis:

Return on Equity (ROE)

ROE represents a useful data point to analyse performance. It is calculated using the net income divided by shareholders' equity, and therefore represents relative profitability. It is important to note that ROE is mean reverting, and therefore tends to return back to the industry standard as competitors learn about the strategies used by companies with higher ROE.

Telstra has a trailing twelve month (TTM) of 11.28%, which is lower than the industry standard of 14.69% (Investing.com 2023). While this may seem low, their main competitor, TPG, has a ROE of 4.34%, which is significantly lower than Telstra (Investing.com, 2023). As indicated in the strategy section, smaller competitors have significantly increased competition, and the significantly lower ROE of TPG may indicate that TPG is not as competitive against smaller telcos compared to Telstra. Regardless, Telstra is still below the industry average, and will need to become more competitive to revert to the mean ROE.

To better understand the cause for the difference in ROE, a DuPont model can be used, which decomposes ROE into the profit margin, asset turnover and financial leverage.

Net Profit Margin	Asset Turnover	Leverage (assets/equity):
Telstra: 8.4%	Telstra: 0.5	Telstra:2.472
TPG: 9.47%	TPG: 0.28	TPG:1.628

(Investing.com, 2023)

Analysis of the above ratios indicates that Telstra differentiates itself positively when compared to TPG in asset turnover and financial leverage. As such, it indicates that Telstra has a higher sales to equity ratio, and can efficiently use shareholder capital to generate sales.

This is a positive indicator for shareholders, as they can expect higher returns on their investment.
To further investigate the asset turnover discrepancy between TPG and Telstra, the PPE turnover ratio was calculated, indicating the long term asset management quality of the two companies. Telstra was calculated to be 1.08 (Telstra, 2022), while TPG had a higher ratio of 1.51 (TPG Telecom, 2022), indicating that the long term PPE investments of TPG may be higher revenue generating than Telstra. This further indicates that the higher asset turnover ratio of Telstra may be a more short term focused metric, while TPG has longer term better asset turnover management.

Leverage was another key differentiator identified in the DuPont analysis, and can be further explored using liquidity ratios and solvency ratios. The current ratio for Telstra is 0.59 (Investing.com, 2023), while the current ratio for TPG is 0.6 (Investing.com, 2023), indicating that they have similar abilities to repay their short term liabilities. In terms of the solvency ratios, the debt to equity ratio of TPG is 0.627 (TPG Telecom, 2022), while Telstra's is 1.47 (Telstra, 2022), indicating that TPG is better able to pay off their long term debts.

Cash Flow

Analysis on the cash flow statement indicates that Telstra is likely in the maturity stage, commensurate with the strategy analysis conducted before. Cash flows from operating activities were $7249m in FY22 and $7231m in FY21 (Telstra, 2022), indicating that they have positive operating cash flows that have stabilised. Cash flows from financing activities are negative, at -$3971m for FY22 (Telstra, 2022), likely due to repayment of debt or from other financing activities conducted in growth years.

Forecasting:

To forecast Telstra's future performance we focus on its revenue growth, its margins, the change in expenses and major changes in important balance sheet items. We also broadly assess the macroeconomic environment and forecast its effect on Telstra's future business.

As macroeconomic trends influence most of Telstra's numbers, we will address it first.

Macroeconomic forecasting in regards to Telstra

Parts of Telstra's business can be considered a staple business as people will not likely cancel their internet contract because of a worsening economic condition. However, parts of Telstra's business can definitely be considered discretionary and therefore a worsening macroeconomic environment has a larger impact on revenue. Customers are more likely to refrain from buying a new premium phone every two years when they are under economic pressure.

Interest rates increased over the last one and a half years by almost 3.5%. Considering Telstra's relatively large debt financing, this increase in interest rates will have a noticeable impact. These interest rate hikes will likely slow the economy to some minor extent as well. Even though the Australian economy seems resilient, global uncertainty will inevitably decrease discretionary spending. Whether the RBA will continue to increase rates largely depends on new inflation numbers. Regardless of further increases, the impact is already measurable in some sectors like real estate.

Forecast revenue

To analyse Telstra's revenue growth we need to assess the different streams of income to establish a sound forecast.

The largest part of revenue comes from their mobile segment. CEO Vicki Brady stated that this segment will be even more important in the future as parts of their legacy business continue to decline. Telstra's growth in the mobile segment was strong recently, as Optus customers switched due to the data breach, as well as roaming revenue increased due to more international travel post-COVID. Due to these trends, strong growth in 2023 is expected with a return to average growth rates of 2-3% in the following years. Considering Telstra's large market share, we expect Telstra's long-term Mobile revenue to only be in line with Australian population growth plus inflation.

Also all other 'fixed' revenues profited from the Optus data breach but customer acquisition is likely to return to long-term growth rates soon.

Their consumer and small business (C&SB) segment is stagnant as their legacy landline business is decreasing while their Subscription video on demand will likely continue to grow despite poor recent results. If we assume that Foxtel subscriptions continue to grow, we balance out the loss of revenue due to a reduction in landline services. We expect that trend to continue long-term, so that C&SB revenue growth is in line with Mobile revenue growth. That is particularly likely as the recently reported average revenue per user is up in this segment over the last years, which indicates that the consumer accepts Telstra's high prices.

They are actively losing customers in the Enterprise segment. There are no apparent reasons for that trend. Some loss was expected in 2020 and 2021 as enterprises introduced more home offices, but despite a return to in-person work, this trend is not slowing down. As management was not able to provide any concrete solutions on how to stop the trend, I assume that this trend could persist as competition is high. We believe that Telstra might struggle with its customer retention long-term. It has a high market share and asks for high prices, so that there is a real risk that Telstra will continue to lose customers. A marginal decline in customers is the most likely outcome leading to a decrease in real revenue but a slight increase in nominal revenue of 1%.

The Wholesale part on the other hand is mostly a legacy business and management acknowledged the need to focus on other income streams. The recent loss was large but as Wholesale only makes up a small amount of total revenue, it is not vital for Telstra's business model.

Their international segment experiences very high growth due to their acquisition of Digicel Pacific. Otherwise, the segment is mostly flat. It is likely that Digicel Pacific will continue to increase their revenue by 10% CAGR as its market including Fiji and Papua New Guinea is not as established as Australia. Considering that Digicel Pacific makes up 40% of international EBITDA, we assume a 4% increase of this sector for the medium-term future.

Telstra's infrastructure segments InfraCo and Amplitel both experienced decent growth in the past, which is due to the importance of telecommunication infrastructure, which is likely to remain an important industry for years to come. That said, management said that InfraCo might be spun off and partly sold, which would lead to a large one time gain but less recurring revenue. The report here assumes that InfraCo will not be spun off. That said, a large one-time profit might help Telstra to finance its continuous large returns to shareholders. Amplitel is likely to continue with strong revenue growth of 5% as 5G networks is expanding to more remote areas. As 5G requires a lot more hardware than previous network technologies, a strong demand for this type of infrastructure is to be expected.

TelstraHealth and other smaller businesses within Telstra experience continuous revenue growth as they are still in their growth phase and mostly unprofitable. As the growth rate can change significantly depending on the amount of acquisitions that Telstra does, we assume a recovery from the pandemic in 2023 and a continued 5% growth rate in the years afterwards.

Overall when summing up all the numbers, a revenue growth of 2.0% for FY2023 and a long-term revenue growth of 1.5% is the most likely forecast for Telstra. This assumes that the new management executes well and hence growth in key segments such as mobile and C&SB remain strong.

Forecast leverage

Due to major acquisitions such as Digicel Pacific, Telstra increased their debt load by approximately $2b over the first half of FY23. However, as Telstra paid off a large part of their debt over the last 2 years, their total debt load is not as high as it was. While their current leverage is only 40%, the overall Debt-to-EBITDA ratio increased to 3.07 due to weaker revenue. We suspect that Telstra will use its earnings to pay off its liabilities, so that their leverage decreases in the coming years. Despite that, the interest expense Telstra experiences is more severe than in previous years, as interest rates rose. In the last half-year, Telstra's operating income was only 4x higher than their interest expense, which is significant.

Forecast tax

CFO Michael Ackland stated that he expects their effective tax rate for FY23 to be around 30%. This is in line with their effective tax rate that they had in past years including the pre-COVID era. Considering the given facts, I do not think that the tax rate will significantly change in the coming years.

Forecast margins

Telstra's growth margin, operating margin and net margin contracted in the years leading up to COVID and only recently started to recover. Looking at their T25 plan, we can see that they plan to decrease their operating expenses further by a total of $500m. However, their half year report 2023 showed that almost all operating expenses increased. This is likely due to competitive and inflationary pressures. That is why the operating margin is likely to decrease in the near future but might expand longer term. Overall the gap between gross margin and operating margin already decreased significantly over the last 5 years as the selling, general, and administrative (SG&A) expenses dropped significantly due to strategy changes. Due to that already large cut we doubt that Telstra will be able to cut its operating expenses by much in the future. In contrast to that COGS and depreciation/amortisation were reasonably stable over the last 5 years despite fluctuating net margins. That said, CAPEX over the last 5 years were decreasing. Therefore, we believe that the depreciation expense, which was slowly increasing over many years, will pivot and decline in the coming decade.

A large part of the recent expense increase is due to their newly acquired company Digicel Pacific. Therefore, while margins will not improve in the short run, we believe that they will in the long run, due to their strategies to cut costs as described in the Strategy analysis.

As mentioned above, the increase in debt will inevitably lead to an increase in interest expense, which will keep the net margin low at 7.5 - 8% until FY 2025 when we expect it to increase to 10 - 11%.

Hence, we assume an optimised gross margins of 21%, optimised operating margins of 14% (assuming they can cut their operating expenses further by a total of $500m) and optimised net margins of 11%.

Balance sheet forecast

Due to the difficulty of predicting balance sheet items, we will focus on positions that are either large or will be subject to significant changes.

As Telstra is a very stable mature company, most positions are rather stable rather than showing a clear trend. As Accounts Receivable is within the same range over the last 10 years, we expect them to have the same amount in the future, particularly because the sales numbers are not increasing by much. Similarly Property, Plants & Equipment only increases by 1% annually. As the recently spent cash on capital expenditures is significantly lower than that 5 years ago, we expect PP&E to slowly decrease as more assets will be depreciated.

Due to the recent acquisition of Digicel Pacific, Telstra's Goodwill increased by $250m. This amount needs to be tested for impairment and therefore expenses might increase at some point.

As stated above, Telstra's net debt increased by $2b to finance the acquisition Digicel Pacific. A relatively large portion of the total debt needs to be repaid within the next year and is therefore current. Considering that Telstra reduced their debt over the last years, the recent increase only increased the net debt to its 10 year average. Despite that, we believe that as part of Telstra's strategy to become leaner, it will try to repay a large part of its debt gradually over the next 10 years.

While the number of shares outstanding was very constant over the last 5 years, the new management increased their share buyback program in the first half of FY23. While the increase in retained earnings is about as high as the equity decrease due to dividend payments, we assume that total equity will gradually decrease by 0.3% annually over the next 5 years if we assume that share capital decreases by 1% annually due to buybacks.

When projecting these numbers on the net income, we assume that as soon as the cost cutting implementations are implemented, Telstra will experience a rather large increase in net earnings due to margin expansions. Considering the financial report of first half year 2023, we do not expect significantly different earnings numbers in FY23 compared to FY22, but believe that a 15.5% CAGR in net earnings can be achieved for the 3 years afterwards, until optimised margins are reached.

Valuation:

To approximate the value of Telstra, we use a discounted cash flow model and a residual earnings model.

To calculate these models, we use the revenue numbers as described in the forecasting section. To calculate the net income, we multiply these numbers with our estimated net margin, that takes the strategic changes at Telstra into account.

The cost of equity was calculated by using the CAPM model, taking the current RBA interest rate 3.6% as risk free rate (Reserve Bank of Australia, 2023), taking 0.41 as beta, which was calculated taking the 5y monthly average and taking 6.5% as equity risk premium, which was the value provided by the 2022 Valuation Practice Survey published by ANZ (Chartered Accountants, 2022). Using these numbers we established a cost of equity of 4.79%.

In contrast, the cost of debt was calculated by taking the latest sold bonds, which Telstra sold with a 5 year duration and a 4.9% coupon rate in January 2023 (Weinman A, 2023). Due to the recent rate hikes, older long-term debt was likely sold at lower rates but to be conservative, we use this value as average for the coming years.

As Telstra has a debt weighting of 60.6% (and therefore is 39.4% equity financed), we established an weighted average cost of capital of 4.86%.

When conducting both models, we can see that the calculated price of both models is very much in line with the current share price. The calculated target share price ranges from $4.29 to $4.39, while the current share price is $4.27.

Even though over the last 5 years CAPEX were decreasing, we assume that the expenditures will start to plateau as the company is already a lot leaner. Lagging behind the lower CAPEX, depreciation will naturally decrease as well. Also while the amount of debt increased over last year due to the acquisition of Digicel Pacific, we assume that the debt will be paid off to a more healthy level of 1x EBITDA. This will decrease the amount of free cash flow over the next 5 years as the debt is repaid.

To perform the residual earnings model, we assume that the new management will continue to create shareholder value by share buybacks. As management communicates that they stress the return of value to investors, it is likely that over the next years, most of the earnings will be used to pay out dividends. Therefore, as retained earnings will remain steady, the share buybacks will cause Shareholder’s equity to decrease by 1.5% per annum in our base case.

The terminal growth rate that was used is 1.5%. That growth rate is in line with long-term inflation. As competitive pressures are high, it is rather unlikely that Telstra will increase their market share. That is why a long-term growth rate of 1.5% is reasonable.

As mentioned before, the fully franked dividend of 16.5 cents and the generally high payout rate are definitely reasons why Telstra as an investment is more popular than the fundamentals of the company would indicate. That said, assuming a share price of $4.27, the 16.5 cents is only an annual return of 3.8%, when comparing it to the risk free rate of 3.6%.

The sensitivity analysis indicated a wide range of outcomes ranging from a 50% downside to a 84% upside. This is largely due to the potentially varying discount rate, as well as the uncertainty regarding customer retention, as well as margin pressures.

There are 3 major risks that could lead to a decrease in Telstra's share price. Firstly, if the cost of equity increases as investors transition to alternative investments, the valuation can contract significantly, as other riskier investments become more attractive. Secondly, if customers are not willing to pay the high prices as asked by Telstra, the revenue and ultimately net income and free cash flow will decrease. Thirdly, Telstra will not be able to return to their optimised margins that they had before the pandemic. Due to inflationary pressures, Telstra's management called out during their last earning's call that they doubt that they will be able to reduce costs in the short run.

In contrast to that, the 84% potential upside assumes that Telstra returns to their optimised margins, while at the same time retaining customers and returning all free cash flows to shareholders in the form of dividends or buybacks.

Considering the real risks that competitors present, the current valuation of trading at 24x earnings is quite high, particularly as the upside potential due to the maturity and market share of the company is relatively limited.

Outcome	Scenario
Bull case: $7.87 84.3% upside	● Telstra increases their market share ● Telstra increases ARPU in key segments such as Mobile and C&SB ● Telstra decreases decreases their selling, general, and administrative expenses ● Telstra pays back their loans to decrease interest expenses ● Telstra continues to buy back shares additionally to their dividend payments
Base case: $4.20 0.4% upside	● Telstra decreases decreases their selling, general, and administrative expenses to get to optimised net margins ● Telstra keeps their market share ● Key segments such as Mobile and C&SB experience marginal growth ● Telstra continues to pay out their dividend and adds buybacks every other year
Bear case: $2.59 39.3% downside	● Telstra loses significant market share ● Telstra does not manage to cut their costs ● Telstra's income decreases to a point where they cannot continue to pay the full dividend or any buybacks

Investment Recommendation:

Investment recommendation: HOLD

All things considered, Telstra can be a good investment for the right investor. The industry is very stable and internet services will always be needed in the near and medium term future. There is no known substitute and entry barriers for new competitors are relatively high due to the needed infrastructure. That said, existing competitors compress margins. The fully franked dividend, the large returns to shareholders and the low beta of 0.41 makes Telstra a good investment especially for older individuals, who cannot weather volatility due to being close to pension. Despite that, Telstra's net income was volatile over the last 5 years. Due to all the risks that were mentioned in the valuation section, we cannot unconditionally recommend Telstra. The lack of new investments limits the amount of upside potential. Also, it is unknown to what degree the reduced CAPEX spending will affect Telstra's ability to generate revenue in the future.

Hence, we believe that all in all, Telstra could be a good investment if revenue and income streams remain stable. However, that requires very good execution, as well as no other negative events influencing Telstra. Considering the amount of doubt, we believe that a more bearish scenario is more likely than a bullish one and considering that the bullish scenario provides limited upside, we believe that there is a slightly asymmetric risk reward, making Telstra a potentially more risky investment than the average investor is expecting.

References

Australian Competition and Consumer Commission 2016, Competition in the Australian telecommunications sector: Price changes for telecommunications services in Australia, accessed 26 February 2023, <https://www.accc.gov.au/system/files/ACCC%20Telecommunications%20reports%202014%E2%80%9315_Div%2011%20and%2012_web_FA.pdf>

Australian (ASX) Telecom Sector Analysis 2023, accessed 26 February 2023, <https://simplywall.st/markets/au>

Bradstock, E. 2022. Who are the largest internet companies in Australia, accessed 28 February 2023, <https://www.canstarblue.com.au/internet/largest-internet-providers-australia/>

Chartered Accountants. 2022 Valuation Practice Survey, 2022, accessed 08.04.23, <https://www.charteredaccountantsanz.com/news-and-analysis/insights/research-and-insights/2022-valuation-practice-survey-insights>

FactSet Research System, 2023. Telstra Group Limited (TLS-AU), accessed 25 February 2023, <https://login.factset.com/login/xoM4jTODNt1DQZiEFfv2epjgwEy_90OY4PMHmCT4nVWBNoOUq5l1gngk-6goz21COdbrZuVD15k0pCIYD-6Iucp8o8wZ2KRMX8YMq9xq_3_4HnMLvSWXbN42I39yGY3LvVjPTnQGizAhdBPHyQeVlc9v1-pdkV1N2Ma4vhKzebJo3PPStF50hCbFbzttgfkc-k2DaELsEuE/xoM55/4nV6b >

Investing.com. Telstra, 2023, accessed 07.04.23, <https://au.investing.com/equities/tpg-telecom-ltd-ratios>

Reserve Bank of Australia. Cash rate target, 2023, accessed 08.04.23, <https://www.rba.gov.au/statistics/cash-rate/>

Telstra. Annual report 2022, accessed 06.04.23, <https://www.telstra.com.au/content/dam/tcom/about-us/investors/pdf-g/TEL-AR-2022-Spreads-FINAL.pdf>

TPG Telecom. Annual Report 2022, accessed 10.04.23, <https://www.tpgtelecom.com.au/sites/default/files/2023-02/TPG_Telecom-Annual_Report_2022.pdf>

Weinman A. Telstra ends five-year bond drought with first corporate deal of 2023, accessed 08.04, <https://www.afr.com/companies/financial-services/telstra-ends-five-year-bond-drought-with-first-corporate-deal-of-2023-20230301-p5col7>

WSJ Markets, Telstra Group Ltd 2023, accessed 26 February 2023, <https://www.wsj.com/market-data/quotes/AU/TLS/financials >