1 stock for the value song sheet

by Roger Montgomery

In November 2011, Telecom New Zealand became the first incumbent telco in the world to voluntarily split, creating Chorus Limited (CNU) – the owner of New Zealand's existing copper telecommunications network, and Spark Limited (SPK) – the mobile network, and retail business operator.

The New Zealand government's desire for an ultrafast broadband (UFB) network and its wish to see the builder of that network separate to the business of retailing, provided the environment for the separation and allowed Chorus to participate in the fibre network build.

The objective of the UFB Scheme is to connect 75% of the NZ population by 2020. CNU was selected to build the majority of the network and between the date of structural separation and end 1H15, CNU had invested over $1.7b on fibre capability as part of the UFB rollout.

Prior to structural separation, the UBA (Unbundled Bitstream Access (UBA)), which comprises of access to the network ("Layer 1") as well as the electronics needed to connect ("Layer 2"), price was $45.98/month.

Following separation, and having regard to the desire to migrate to fibre and a perceived need to update industry regulation, the NZ Government initiated a process of regulatory review that included an interim review of copper pricing – to be undertaken by the NZ Commerce Commission (CC) – that would set copper prices for the period up to 2020.

In respect of the interim copper pricing review, a staged process was adopted. The first stage, known as Initial Pricing Principle (IPP) was to determine a wholesale copper access price by reference to benchmarks in comparable countries – a relatively quick and easy process.

In the event that industry participants were unhappy with the IPP price, they could request CC to undertake a more rigorous Total Service Long Run Incremental Cost (TSLRIC) approach under a process known as Final Pricing Principle (FPP).

On 5 November 2013, the CC released its (IPP) benchmarking decision in respect of regulated wholesale pricing for CNU's local access network. The price, to apply from December 2014, for CNU's UBA service was $34.44 per month – a 23.4% reduction.

The resultant price reduction came as a shock to participants, would leave a $1 billion hole in CNU's finances and limit its ability to deliver on its UFB rollout obligations. The company suspended its dividend and CNU's share price collapsed from greater than $2.50 in early November 2013 to less than $1.50 by the end of December 2014 and Moody's downgraded CNU's senior debt, and S&P placed it on review for possible downgrade.

What happened next was that the NZ Prime Minister announced that the outcome of the IPP did not reflect Parliament's intent and legislation would be put forward to overwrite the IPP price such that copper pricing was more consistent with fibre pricing. These sentiments are important for the investment case for Chorus.

Unfortunately, to pass the legislation to overwrite the IPP price, the government needed support from minority parties, which it did not receive.

Then CNU and several other industry participants requested the CC to implement the FPP process, under which pricing would be determined using a more rigorous TSLRIC analysis.

With the legislation unable to be passed, CC in

February 2013 initiated the FPP/TSLRIC process which effectively requires the CC (via consultants) to determine the replacement value of the copper network and, using an assumed WACC, determine the price that an owner would need to charge to earn a return on the capital invested.

In December 2014, CC announced a draft pricing decision of $38.39 under FPP, based on a network replacement cost of $7.4B and a WACC of 6.47%; and a delay to completion of the FPP pricing determination, such that a final decision would be reached in September 2015.

As part of the regulatory process, CNU had (via consultants) made extensive submissions to the CC, including that the weighted average cost of capital (WACC) adopted was unduly conservative and that errors were made in the CC's calculation of the network's replacement cost.

Our thesis was that a more supportive regulatory framework would have to emerge for Chorus and as a result, the gap between the market value of Chorus and the replacement cost of the network (a source of margin of safety) would narrow, if not close.

In December this year, the thesis took a step forward, as did the share price, when the New Zealand Commerce Commission announced an improvement to regulated prices for wholesale access to Chorus' copper network.

In summary, the final pricing decision was a significant (and somewhat unexpected) improvement over the interim decision, resulting in meaningful upgrades to consensus earnings forecasts. CNU issued updated FY16 EBITDA guidance of NZ$580 – $600m, which compared with the then current consensus of NZ$569.5m.

The improved financial position also provided flexibility in respect of discretionary capital expenditure (which when profitable adds meaningfully to intrinsic value) and it potentially provides for the reinstatement of dividends. An update on these matters is expected at the half year results in February.

The core of our thesis for CNU is that the regulatory framework needs to encourage investment by network owners, and previous price decisions have fallen short of this.

Further, if the post-2020 review is able to deliver sensible price levels with a high level of predictability, there remains scope for a significant increase in the value of CNU via a reduction in discount rates. And while the share price has now closed on our initial estimate of intrinsic value, we believe there exists ample opportunity for the value of CNU to continue rising.

Chorus (CNU)

Source: *Yahoo!7 Finance, 18 January 2016*

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