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Telstra and TPG, who will win share?

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TPG has confirmed its intention to build a fourth mobile network in Australia with its successful A$1.26bn acquisition of two 10MHz spectrum licenses in the most recent Government tender. The market's reaction has been savage, with the share price of the dominant incumbent operator Telstra, falling by almost 10 per cent since TPG's announcement.

This equates to a reduction in Telstra's market capitalisation of around A$5bn.

To put this in context, prior to the announcement of the spectrum auction results, the major sell side broking analysts valued Telstra's mobile business at between A$28bn and A$33bn. Assuming TPG's decision to build a new mobile network only impacts the profitability of the mobile business (which might not be the case), this implies that the market has reduced its estimated value of the mobile business by between 15 per cent and 18 per cent.

The implied reduction in value might appear surprising given that TPG has indicated that it would breakeven at the EBITDA line if it achieved a market share of 2 per cent. To break even at the EBIT line it would require a 6 per cent share of the market. Clearly it will be targeting a better than break even result in the longer term in order to justify the A$1.9bn of capital it plans to spend of spectrum and the initial roll out of its network. But even if TPG were to achieve a 10 per cent share of the market, how could that translate into a 15-18 per cent fall in the value of Telstra's mobile business?

There are a number of factors that need to be considered when assessing the impact on the value of Telstra's mobile business.

The first is the impact of fixed cost leverage. Telstra is expected to generate an EBITDA margin of around 40 per cent in mobile this year. Once an estimate of the ongoing zero earnings growth capex requirement is included, the margin falls to just over 30 per cent. As a rough estimate, around half of the cost base is fixed and half is variable, meaning that for every $1 of revenue gained or lost from changes in subscriber numbers, free cash flow increases or decreases by approximately A$0.65. So a 5 per cent reduction in revenues resulting from changes in subscriber numbers would result in a 10 per cent reduction in underlying cash flow.

TPG is all but certain to focus on a lower price offer to a price sensitive consumer. Telstra's positioning as the premium network provider with the highest population coverage should provide it with some insulation from TPG's price focus, particularly with its premium and business customer base, relative to Vodafone and Optus. As such, the share that TPG captures is likely to come disproportionally from Optus and Vodafone.

But the impact on valuation will extend beyond the percentage reduction in mobile earning for Telstra.

Fixed cost and capital leverage is an important component to consider when determining the net impact of a change in the competitive conditions in the market.

If we think about the mobile market as a value chain, we can break the market into two segments. First there are the infrastructure owners. This includes the major network operators Telstra, Optus and Vodafone. The second segment is the retail reselling market. This segment includes resellers like Vocus's Dodo and iPrimus brands, TPG, Amaysim and others.

Telstra, Optus and Vodafone are effectively vertically integrated mobile companies across these two segments, whereas Vocus, TPG and Amaysim are only in the retail reseller market.

Revenue for the overall value chain is the aggregate revenue for the retail reseller market, whether that be Vocus, TPG or Telstra. The infrastructure segment charges the resellers for access to their networks. For the pure resellers, this is a commercial cost. For the vertically integrated players it's a notional one.

What TPG is essentially saying by building another network is that the return being generated by the infrastructure segment of the market is attractive enough to invest its capital on a marginal basis. This will add fixed capital, cost and capacity to the overall value chain. As such, TPG's investment will change the competitive dynamics and returns in infrastructure segment relative to the retail reseller segment.

From an infrastructure owner's perspective, the market size has not changed as there is not an increase in the number of mobile customers in Australia. However, there will now be more competitors in the market, fragmenting the volume base. Infrastructure is higher fixed cost than retail resale due to the capital maintenance costs, as opposed to the variable nature of handset subsidies within the reseller cost base. So a change in volume has a much larger impact on the margins in the infrastructure segment of the value chain than in the reseller segment. This creates margin and return leverage.

The high degree of margin and return leverage from volume changes incentivises infrastructure owners to target incremental volumes. The three player market in mobile infrastructure has proved to be relatively stable from a competitive perspective. Adding capacity and another player from which to purchase capacity should improve the negotiating power of the pure resellers in the market. The extra capacity being added by TPG, and reduced share for Optus and Vodafone means an increase in excess capacity, which has a low marginal cost. Vodafone is likely to be the most significantly impacted as TPG will migrate its existing customer base from the Vodafone network to its own network. The question is how aggressive will Vodafone be in trying to replace this lost volume?

So the impact on pricing and margins in the market is likely to extend beyond the impact of TPG lowering its price points. A stronger negotiating position for pure resellers like Amaysim and Vocus is also likely to see their retail prices fall as a competitive reaction to their ability to negotiate lower network access costs.

The other question is whether lower prices in the market will drive a significant enough increase consumer demand for mobile to hold the overall revenue for value chain constant.

Irrespective, higher capital investment and fixed costs on a relatively unaffected industry revenue line means lower returns and profitability for the industry in aggregate. Lower sustainable returns mean that the valuation of the businesses falls by more than just the reduction in earnings. Therefore the value of Telstra's mobile business is not only reduced as a result of the lower forecast base of earnings, but it also needs to be de-rated to reflect the reduction in the sustainable return on capital going forward.

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