Hold the phone, how are the telcos?

by Roger Montgomery

The telecommunications sector endured a horrible year in 2016 with slumping share prices reflecting the uncertainty of the viability of various business models ahead of the completion of the NBN rollout. Downgrades, writedowns and capital raisings are just some of the events shareholders themselves have had to endure.

So how should investors think about a complex and extremely dynamic sector and what are some of the considerations before deciding whether valuations have become attractive since the sell off?

Fifteen years ago, life was simpler, a residence enjoyed dial-up Internet access, with speeds 100 times slower than today, shopping catalogues clogged mailboxes, CDs and DVDs clogged shelves and drawers, and teens argued about who could use the phone next. Smart phones didn't exist and the only wireless device was the TV and roller door remote control. Back then it took less time to walk to the 'video' store, come home with a dvd, watch the movie and return it, than it did to download one.

The speed of change is now as fast as the connectivity we demand from our ISP and competition is ensuring prices keep falling. Meanwhile, ever faster speeds create new service categories that device manufacturers and service providers must enable access to.

This recipe of promising more data and services at ever-lower prices is not an easy menu item for operators to deliver. Combined with more than 110 companies offering access to the NBN alone, it makes navigating the future very difficult for investors and therefore valuing opportunities almost 100% guesswork.

Despite declining prices, Australian telecommunications consumers have still had to pay substantial price premiums, particularly to Telstra, over their overseas counterparts, as well as accepting slower and inferior services.

Telstra has benefited most from consumers' unwitting willingness to pay premium prices. Limited competition, for example where Telstra is the only provider of services (to 46% of fixed line services, for example), means some 3.5 million consumers are adversely affected by the market structure.

Meanwhile, it is argued the subsidisation of Telstra, through the Universal Service Obligation (the obligation placed on Telstra to ensure that telephone services, payphones and prescribed carriage services are reasonably accessible to all people in Australia on an equitable basis) entrenches its market dominance. It might be just one reason consumers are paying more. Other reasons include the disparity in spectrum ownership between operators, which acts as a barrier to competition.

Regardless, data demand is surging. Demand for data on fixed networks grew by 40% from 0.96 million terabytes (TB) to 1.3 million TB, and mobile data increased by 35% from 72,000 TB to 110,000 TB. A significant contributor to this rising appetite for data is the preponderance of audio-visual streaming services such as Netflix, Presto and Stan, while a rising number of connected devices in homes – from an average of eight in 2016 to more than 20 in the next four years – will continue to contribute to data demands.

As an aside, price is also driving data demand. In just the last four years, prices for similar data plans have fallen by more than 80%.

This growth in data demand has focused competition between providers of both fixed line and mobile services resulting in increased data quotas and

bundled subscriptions to streaming services.

And to top it off, the industry will change significantly as the NBN rolls out. The NBN rollout and migration of consumers to the network will raise issues for regulators, the industry and for consumers. New bottlenecks may be discovered, there'll be new pressures on battery backup arrangement, Telstra may gain a competitive advantage from access to significant information flows, while smaller service providers, will demand and require a competitive and efficient aggregation and backhaul market.

To compete against Telstra's circa 60% market share (and 51% of wholesale NBN connections compared to 24% for TPG and 8% for Vocus) either significant scale or dominance of a growing niche (e.g. VOIP) is required. The result has been a wave of land-grabbing mergers and acquisitions, such as Vocus/NextGen/M2 and TPG/PIPE/AAPT/iiNet.

In 2016, total telecoms services revenues exceeded $40 billion and grew at 2.0% for the 12 months to June 2016. Much stronger-than-aggregate growth is being generated by second-tier providers, however Telstra still dominates.

Ongoing advances in the digital economy as well as multi-industry use of the infrastructure and the Internet of Things will see an ongoing increase in wholesale revenues and open up opportunities in data analytics, cloud computing and services that haven't been imagined yet, while the connection of literally billions of devices puts pressure on the infrastructure.

As the future moves towards the NBN, it is believed a more level playing field will be created, but as I mentioned earlier margins will continue to be pressured. If you're thinking the telco sector in Australia is an incondite gallimaufry, you're not too far from reality.

Telstra (Sell/Hold)

Telstra is Australia's largest telecommunications provider by market share and market capitalization. It offers mobile, hardline telephone and internet services to residential and business customers, as well as wholesale services to Internet Service Providers and Retail Service Providers. Subscription services (e.g. Foxtel) are provided through its subsidiaries.

Despite accusations of monopolistic behavior, investors have not seen rising profits from Telstra for many years and a large revenue hole will emerge after consumers exit the company's copper network and are invited by all providers to join the NBN with them. Indeed, the company's forecast 2017 profit will be no bigger than 2008. This is partly because a very high proportion of the company's earnings are paid out as dividends, meaning relatively little profit is retained and reinvested for growth. Investors should probably think of Telstra shares as they might a bond. Steady dividend income can be attractive but growth is required to fend off the ravages of inflation and maintain purchasing power.

Whether we rate the shares a hold or sell/avoid depends on the price that has been paid. Investors who purchased shares when they traded below intrinsic value estimates in 2010, have generated an attractive yield and enjoyed some capital growth and can continue to hold. Be mindful that rising bond rates will render the virtually fixed dividend from Telstra less attractive.

TPG (HOLD)

Established by the reclusive David Teoh more than three decades ago, and after a steady stream of acquisitions, TPG is now Australia's second-largest provider of fixed broadband services behind Telstra, with a market capitalization of $5 billion. That market capitalization however is significantly lower after the shares fell 53% from more than $12.50 to the current price of $5.81.

TPG acts as owner-operator of voice, data and internet network infrastructure, provides NBN, ADSL2+, fibre optic and ethernet broadband access, telephony services and SIM-only mobile plans to residential users as well as SMEs (small and medium enterprises) larger companies, government enterprise, and wholesale customer RSPs. Importantly, TPG owns fibre-optic networks connecting capitals and metro areas, and it owns the international PPC-1 submarine cable connecting Australia with the USA and Asia.

The company recently announced further capital expenditure of $600 million to build its own mobile network and become the fourth mobile network operator, joining Telstra, Optus and Vodafone.

VOCUS (HOLD/AVOID)

Like TPG, Vocus Communications also went through a raft of about 20 acquisitions. The key difference however has been a recent admission that those acquisitions were poorly managed, failed to be properly integrated and therefore, by definition, were overpriced.

Vocus began life as a provider of telecommunications and network services to the business sector. After merging with Amcom and acquiring its network assets in 2015, Vocus built its own fibre and data centre network across Australia and New Zealand. In the same year it was then transformed, becoming Australia’s fourth-largest residential broadband internet, through its merger with M2 Telecommunications, which owned the Dodo, Commander and iPrimus brands. Its acquisition of Nextgen also gave it a national fibre backhaul network.

The recent downgrades will be followed by a significant time delay before the company can safely say it has integrated its acquisitions, merged cultures and extracted synergies. It will be some time before the outlook for this company is devoid of disappointment risk.

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