OPINION
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Are Telstra shares good value or a value trap? Look at broadband and mobile.

by **Mark Draper**

Telstra looks cheap on a valuation model, but is it a value trap? The trouble with valuation models is that they rely on inputting assumptions.

We are of the view that it is better for investors to spend time thinking about what is likely to alter the inputs of valuation models, such as margins and competition, rather than finessing the model itself.

Telstra has a dominant market position, the best infrastructure in the country and receives high margins for its services, but it trades on a price-earnings ratio on a historic basis of less than nine times.

The latest trading update from Telstra showed deteriorating earnings and falling margins. The bright spot was that free cash flow was at the upper end of forecasts, while earnings was at the low end.

The dividend at 22¢ a share for this year was confirmed, putting the stock on a juicy yield of more than 7 per cent fully franked. The dividend on a medium-term view, however, is under a cloud – particularly once the one-off NBN payments stop. It is important for investors to look beyond today's yields that may be illusory and to concentrate on the future earnings of Telstra in order to determine value.

Telstra earns most of its money from broadband and mobile divisions, so it is critical that investors understand what is taking place in these divisions.

The core earnings of the mobile division are under pressure. After years of customers flooding to Telstra's mobile network, a recapitalised Vodafone is growing market share. TPG will turn on its network later this year, initially offering free service for six months and then offering plans at a jaw-dropping $9.99 a month.

Average revenue per user in Telstra's mobile division is about $65 a month today, but TPG and other competitors are likely to force this to below $50 according to analysts at Intelligent Investor. Telstra enjoys margins from its mobile business of about 40 per cent, but this margin, as well as customer numbers, is under threat.

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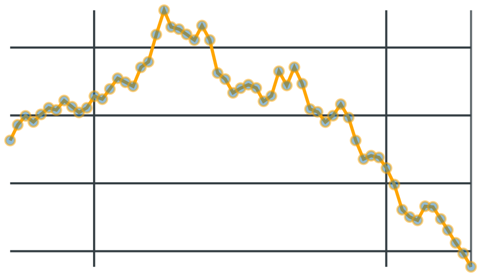

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The NBN offers no comfort for Telstra shareholders either, as about 180 NBN resellers are fighting for market share.

The economic model of the NBN looks challenged. But even if access charges to NBN resellers were to fall, there is no certainty that this would improve margins or simply be competed away. As the NBN grows it transforms Telstra from an asset owner into a reseller.

The 5G network, which is to be launched next year, potentially makes parts of the NBN redundant according to several institutional investors. That is a potential positive for Telstra as it would receive income directly from 5G customers, most likely at a higher margin than reselling the NBN. The unknowable question, however, is how much Telstra will need to spend to buy 5G spectrum.

Roger Montgomery from Montgomery Investment Management believes the ability for Telstra management to cut costs is under-appreciated by the market. Telstra has already announced cost savings of $1.5 billion. But if larger savings can be made, this could help fill the forecast earnings black hole of about $3 billion.

Telstra is an outstanding mobile operator with infrastructure advantages, but the risky thing is its ambition to offset declining broadband and mobile margins with a plan to become a global technology business. If management can execute this strategy well, shareholders should be rewarded, but it carries material execution risk.

Telstra management plans to provide a critical update to the market later this month about plans for the business.

It seems there is universal agreement that Telstra's earnings are in decline for the foreseeable future. So despite the share price having some valuation appeal, we are likely to wait until the update later this month before reaching an investment conclusion.

General advice only. Mark Draper is a financial adviser with GEM Capital Financial Advice.

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