Financial revelation time for telecoms players

Ian Martin, telecommunications analyst at ABN AMRO, examines the latest financial results from Telstra, Optus Communications and AAPT Telecommunications

Telstra

Telstra can sustain 8-10 per cent growth medium term

The key indication of the Telstra result was the slowdown in organic sales growth. (To see this, it's necessary to net out the one-off effects of the consolidation of Pacific Access, the directories business and low value refile or transit traffic.) Sales growth is expected to decline further with ongoing loss of share and price pressure.

Allowing for the interest effect of the additional $3 billion borrowed to pay the 1997 special dividend, EPS (earnings-per-share) growth was a good 11 per cent. We are moderately concerned that most of this has come below the EBITDA line; that is, it was due to changes in depreciation and tax rather than operational improvements. Although sales increased 6.6 per cent, costs rose 12.6 per cent.

The operating performance is in part a result of transit traffic with low EBITDA margins below five per cent. But costs are still high in large part as Telstra is spending more to develop new services. It is one of the best telcos at drawing on new sources of revenue.

)Also, much of the cost increase was in provisions which doubled to about $400 million. Gains here in FY99 and from superannuation reductions should deliver EPS a little over 10 per cent in FY99, and help in FY00.

Basic versus high value services

Broadly, Telstra will struggle with basic service growth as it has the majority of a market in which prices and share will fall. (The key growth item was actually fixed-to-mobile revenue which propped up long distance revenues).

There is good growth in high value services especially data (up 11.4 per cent) with a lot more to come. For instance, the Internet is in the early stages of longterm growth.

A growth feature is the range of joint ventures being set up to exploit emerging opportunities particularly related to forms of electronic commerce. This helps Telstra draw on a range of expertise beyond its core business.

International and mobile are two other feature areas for growth

In international, Telstra has the potential to rapidly increase earnings offshore on a low base by drawing selectively on its domestic expertise. It has indicated what looks like a well considered international strategy expanding points of presence in selected locations. As a go-getting company (in terms of new service development) this is a positive development as it increases areas in which it can draw revenue from new services. For instance, there is evidence of strong growth from a low base in New Zealand and the U.K.

Performance of mobiles causes some concern although growth still looks good. Year-end subscriber numbers on Telstra's two mobile networks fell short of forecasts (e.g. GSM was 1.75 million against 1.77 million). With Vodafone's strong growth, Telstra is losing aggregate mobile share more quickly than expected (56.3 per cent at year-end against a 57.1 per cent forecast). Worse, it still has 1.32 million AMPS customers to be migrated so its CDMA (Code Division Multiple Access) strategy may prove to be very important for value.

Fortunately, average revenue is holding up as new services are added. It fell only 5.9 per cent to $737 million in FY98 (compared to a fall of 12.7 per cent in FY97) and is expected to slow further as AMPS is phased out. CDMA offers more revenue prospects. Further, Telstra has a good source of fixed-to-mobile revenue.

Dividends: scope for growth

Normal dividends were in line with market expectations. There seems little prospect of a significant (20 cents per share-plus) special dividend in FY99 given Telstra's desire to retain flexibility in the face of

rapid change and uncertainty: competition, technology, regulatory impact, Asia and the search for new sources of revenue. (In any case, these factors are likely to be persistent for some years). Telstra noted it would fully frank FY99 dividends but may not be able to fully frank FY00 dividends.

Growth requires re-investment

Telstra is a growth business in a high growth sector. It can make a good case for balanced reinvestment retaining a larger portion of earnings: several opportunities appear on the horizon including data, Internet, cable Internet, mobile and wireless data and a targeted approach to selected international opportunities. In short, the balance sheet may look a little lazy now but it will need to work hard into the next decade in order to promote growth.

Returns to shareholders

Return on equity is about four per cent while return on book value of equity is a hefty 27.1 per cent. This means Telstra's share price growth and a 40 per cent ploughback is only 1.6 per cent lower given the incremental and partially defensive nature of further investment. But ongoing high capital expenditure reduces free cashflow to about $900 million, only 1.1 per cent on EV. If LT cashflow growth is 8.2 per cent (see ABN AMRO September 1997 float study, page 17) then cashflow return to shareholders is a good 9.3 per cent, higher than its likely cost of capital

Optus
Communications

Optus Communications strong longterm growth

Optus produced another strong result with growing revenues and improving margins. EBITDA growth was a healthy 35 per cent and would have been far higher but for the full year effect of the Optus Vision consolidation. FY99 promises more, led by mobile, well supported by business services and data but with local services showing great longterm prospects.

In fact, FY98 was a year of cost control, which may have contributed to slower revenue growth (from 30 per cent to 16 per cent). FY99 should see this redirected somewhat towards:

- Improving average revenue per customer;
- Restructuring product mix to improve margins; and
- A greater focus on marketing to lift sales.

This strategy should maintain sales growth at 16 per cent (on a higher base), sustainable with new mobile products and as local service comes onstream.

Long distance revenue was eight per cent, supported by a late change in payment arrangements with Telstra and transit traffic.

Long distance will also grow as it is packaged with local service.

Mobile revenue was slightly below projection as subscriber growth fell in Q4; but average revenue per user (ARPU) seems to have settled at a good level as AMPS is phased out.

Optus also reports a strong improvement in mobile quality of service which should help a renewed marketing push in FY99.

Pay television is slowly rationalising but revenue growth remains sluggish.

Business Network Services (BNS) was the highlight showing strong growth from direct connections.

A new revenue line is Internet Protocol of $12.5 million. Strong future growth is expected through Optus's ISP Microplex and cable Internet maybe a year or so away.

Cost reduction

Staff numbers dropped from 7,176 to 5,745 in the year (not counting 500 contract staff). Further trimming is likely but minimal as the focus turns to staff quality as revenue drivers.

Further cost reduction is targeted:

- through further outsourcing of data development;
- lower intercarrier payments driven by AMPS phase out, lower interconnection charges and increased use of its own long distance and local networks.

Balance sheet and capital costs

Debt seems to be relatively stable at around $3.4 billion and cashflow is strong enough to sustain current commitments. But cash timing as local rollout proceeds may add pressure.

AAPT
Telecommunications

AAPT Telecommunication's maiden annual result fell well short of its initial prospectus forecast projections and only marginally beat its revised prospectus forecast. Sales performance was strong but seems to rely overly on narrow margin revenues such as resale.

Poor cost control, difficult in a growth business, was the primary cause of earnings under-performance but the truth is that the company relied overly on rapid regulatory change. This may be more instrumental in driving FY99 results.

Ian Martin

Recommendations may not always be appropriate and investors must consider their own circumstances.