Alphinity
INVESTMENT MANAGEMENT

Sector spotlight

September 2016

Each quarter, Alphinity Investment Management's portfolio managers share their expert views on the trends and themes emerging within their relevant sectors. This quarter, **Bruce Smith** shares his thoughts on the current trends and outlook for the **telecommunication sector**.

Who: Bruce Smith

Role: Portfolio Manager

Industry experience: 30 years

The telecommunications sector is made up of a handful of companies but the most substantial is Telstra with a market cap of more than $60 billion. Telstra presently makes up more than 4% of the ASX300 so it has the opportunity to be a meaningful positive or negative contributor to portfolio returns. It was a great performer between 2011 and late 2015, rising from below $3 per share to almost $7, in addition to paying out 28-30c each year in dividends. Since then it's come off sharply: Telstra is now back close to $5 and signs of stress have emerged. Alphinity's portfolios have been underweight the sector since September 2015.

What's happened since Telstra's highs of 2015?

There are a few things in play here. From our point of view the most significant thing is that Telstra went from being in an earnings upgrade cycle to having a series of earnings downgrades, starting with the 2015 financial year result last August.

For some years the market had been underestimating what Telstra could earn and, as its stronger results came through, had to keep revising estimates upwards. Our experience has been that an upgrade cycle usually leads to outperformance and this was borne out for Telstra between 2011 and August last year. But, as often happens, the market became over-optimistic, upgrading earnings expectations to the point that Telstra couldn't achieve them and a re-assessment has since taken place, resulting in a series of earnings downgrades. We went underweight in September last year.

Since then, a few things have happened to make the market even more uncertain. The new CEO, in place for about a year now, started talking about greater expansion into Asia. Telstra has been operating in Asia for decades but it's fair to say its last major investment there, which was made at the peak of the tech boom in 2000, didn't end well. More recently there have been a number of smaller but mostly successful investments such as Chinese online real estate site Soufun and online automotive site Autohome – both of these generated value for Telstra. But the project being pondered earlier this year was to join with a Philippines-based conglomerate to partner in a new mobile phone network there. The conglomerate owned the spectrum required and Telstra had plenty of capital and the expertise needed to roll out mobile networks in challenging conditions – a perfect match, surely. Telstra encountered a lot of resistance from shareholders and ultimately dropped the plan, but the fact it was considering putting a large amount of capital into an already saturated, low income market raised concerns about its capital allocation discipline. That Telstra ultimately pulled out, possibly suggests those concerns were unfounded.

More recently, developments on the domestic front raised different concerns: there were a series of service outages earlier this year on its market-leading and premium-priced fixed and mobile phone networks. Telstra charges noticeably more than its peers but has been able to retain a very strong market share because of its reputation for high service reliability. The odd instance of network failure might be forgiven but several happening in a short time period raised questions about whether enough was being spent on network maintenance. Maybe it should spend significantly more? Of course there were squeals of delight from the smaller players who are now focused on winning share based on their own networks no longer being inferior. Vodafone knows from bitter experience what it is like to be the butt of jokes after it went through similar issues a few years ago: it took several years and much investment in the network to start to reverse public perception. Now Telstra is doing the same thing, spending an extra $2-3 billion to bolster the quality and reliability of its networks. This is right for the long term sustainability of the business, but will come at a cost to earnings and returns in the short term.

So, where to from here for Telstra?

Telstra is by no means a basket case: it has a very strong balance sheet, strong cash flows, a high return on equity and, importantly, a high and sustainable dividend. In the current low rate environment a yield of about 6% with tax advantages on top of that is very appealing to some investors and may prevent the share price from getting too much lower than it is now. Of course if any doubt arises about the sustainability of the dividend that support would fall away. But we've found that most of the time it is the direction of earnings expectations that drives share prices, so we will mostly keep looking at earnings revisions: a sign of upgrades starting to happen on a sustainable basis (i.e. not because of one-off factors like a buy-back) might be a sign that we should reassess the underweight position.

For more information:
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