

30 September 2011

TELECOM DEMERGER COMMENTARY

What is Proposed

On Wednesday 26th October, Telecom shareholders will vote whether to demerge our second largest company by market cap into two listed companies - Telecom Corporation (New Telecom), and Chorus Group (New Chorus).

The demerger will be achieved by a court approved scheme of arrangement. Telecom shareholders will be issued with 1 New Chorus share for every 5 Telecom shares they hold. They will continue to hold 5 shares in New Telecom.

The key thing for investors is to realise that following demerger, they will own exactly the same as they did before. However, the ownership will be in two separate companies rather than one. Shareholders will not be required to pay any money, nor will they receive any.

The demerger documents consist of over 500 pages, but shareholders can also access slides published for the Telecom road show which summarise the proposal.

For those who need a market and company overview the Grant Samuel independent report is part of the large document sent to every shareholder. Financials forecasts have also been subject to review by Telecom's auditors KPMG.

Telecom needs 75% approval for the demerger from the separate meetings of bond holders and shareholders for the proposal to succeed. Bond holders overwhelmingly approved the scheme at their meeting on September 30th.

Background

Since 2008, Telecom has been run as two "operationally separate" units, Telecom and Chorus. However they share a common ownership and Board. The demerger proposal will completely separate them into two separate legal entities with no common shareholding and with their own unique governance arrangements.

This new model of "structural separation" has been proposed in order to allow participation in the upcoming ultra fast broadband initiatives and creates opportunities that would otherwise not be available to Telecom or its shareholders.

What you will end up owning shares in.

New Chorus

The demerger is essential if New Chorus is to secure \$929m of funding from the government's Crown Fibre Holdings for the installation of ultra fast broadband, fibre optic cable. The total \$929m investment will be split equally between interest free debt repayable from 2025, and non-voting shares which attract dividends from 2025 and accompanied by warrants which are designed to allow Crown Fibre Holdings to participate if total shareholder returns are above 16% pa.

While New Chorus can charge businesses, it must link households to the new network free of charge, promote the new network, and comply with considerable oversight of its dealings, especially with Telecom. In addition, New Chorus will have to fund an additional \$450-\$600m to complete the build of the communal part of the infrastructure, although this will be over an extended period.

New Chorus really needs the ultra fast broadband contract to arrest the decline of its existing fixed lines business. Under the deal, Chorus will install cable in 24 of the 33 designated areas of New Zealand, with other areas covered by other groups. New Chorus's cabling will have to pass 149,000 premises by 2013 and 106,000 premises each year thereafter. Chorus already owns and maintains 130,000 km of copper cable, 27600 km of fibre optic cabling, 3600 roadside cabinets and 602 telephone exchanges, so it is a very large infrastructure operation.

The Chorus division of Telecom is currently accelerating the delivery of faster broadband services along this network by software upgrades. It is already the largest supplier of fibre optic cabling in the country, and would need to continue to build in competition with the government if it is unable to proceed with the Crown Fibre contract.

The duplication would not be in the interests of shareholders or New Zealand, but the government needs to ensure that this strategic infrastructure is held by an independent, New Zealand owned, entity, which can deal with retail service providers including Telecom on a non-discriminatory, open-access basis. As a consequence, New Chorus will be highly regulated and the broadband rollout is subject to many contractual terms including price for a number of years.

New Chorus will be included in the NZX top 50. The financial information in the shareholder booklet is extensive and not always easy to decipher. Essentially, investors must look at the Proforma accounts that have been prepared to mimic as closely as possible the financial results at 30 June 2011 that would probably have been achieved if the demerger had taken place a year prior. These are a subset of the Special Purpose Accounts that have been extracted from Telecoms last audited results, but are quite different as many adjustments have been made to reflect the new capital structures and a whole host of other adjustments largely relating to asset transfers. Full explanations are in section 8 of the shareholder book. The explanations in section 8.2.6 are particularly helpful.

Despite overall reductions in turnover and profit at Telecom in recent years, Chorus will still be a substantial company. Proforma figures indicate a turnover of \$1050m, EBITDA of \$606m and NPAT of \$128m. New Chorus is expected to have total assets of \$2436m and total liabilities of \$2014m including debt of \$1700m.

The board of New Chorus contains a balance of skills and gender. It has particular strengths with regard to dealing with government over infrastructure, lines issues, banking, and electrical reticulation. We think this board will be good for Chorus, but with the regulated operating environment the company will take time to yield and grow.

It is anticipated that New Chorus will set a dividend policy to will pay a 25c per share dividend for 2012. Assuming the demerger occurs on 30 November, the 2012 dividend would therefore be around 14 to 15c for the part year. No guidance is available beyond this. The only guidance for the share price post demerger is a very wide band and will be subject to market sentiment.

New Chorus is subject to ownership restrictions which limit individual ownership to 10% and ensure New Zealand nationals must continue to hold at least 50.01% of the company.

New Telecom

Following demerger, New Telecom will remain in the top 10 listed NZX companies by market capitalisation. It will have 4 main operating divisions – Wholesale, comprising sub-networks (backhaul), and international cabling - EBITDA \$174m 14% of total; Consumer – retail sales of data, fixed line, and wireless- EBITDA \$490m 45% of total; Gen-I corporate communication solutions EBITDA \$229m 22% of total and AAPT – Australian wholesale and fibre cable provider EBITDA \$90m 8% of total

To this is added a corporate contribution of 11% of Total EBITDA which comprises technology and shared service allocations.

As Telecom will retain 30 exchanges, plus its wholesale networks, there will be a continuing need for close cooperation and special service transactions with Chorus, however these are strictly governed and will be on an arm's length basis.

The real advantage is that New Telecom will very largely be freed from the stifling regulatory shackles that have so drastically impacted its operations and investor returns.

The Pro Forma accounts show that New Telecom's sales are expected to be \$5071m, EBITDA \$885m and NPAT of \$72m. New Telecom is expected to have total assets of \$4033m and total liabilities of \$2220m including total net debt of \$750-\$950m.(P53)

The board of New Telecom contains a mixture of existing and new directors. There appears to be a balance of strategic, financial and technical abilities. However, with the demise of the regulated operating environment, we might have expected a boost to the marketing skills on the board.

Once current Telecom CEO Paul Reynolds (who has committed to stay to see the Vision 2013 plan and restructuring through), departs some time in 2012, this will only leave Kevin Roberts. We think Reynolds replacement on the board will need to have marketing expertise as core strength.

New Telecom is expected to continue the dividend policy of paying 90% of adjusted net earnings in 2012. No guidance is available beyond this. The only guidance for the share price post demerger is a very wide band and will be subject to market sentiment.

There will be no restrictions on the ownership of New Telecom shares including offshore purchasers.

The Key Issue to Consider

Telecom faces a simple choice. It can either cooperate or compete. History tells us that past efforts to ignore the will of the government have been disastrous. The board and senior management of Telecom has been completely changed over the past five years. As a result, the company has looked with a fresh eye at its options going forward. The current government has made the delivery of high speed broadband to most New Zealanders a key promise, and in this has been unwavering.

In order to gain a share in this project and protect its revenue base in the future, Telecom is required to demerge. This is because the government has decided that private retail telecommunications providers cannot hold a majority share in a local fibre company. If shareholders and bond holders reject the

proposal, then the deal with Crown fibre Holdings will collapse, and presumably be offered to other participants.

The Grant Samuel independent report spends some time looking at the relative financial implications of the demerger. This is summarised on pages 72-73 of their report. In short, they see a net present value increase in virtually every conceivable scenario and put a likely figure of \$500m on this.

While the numbers are useful to know, we see the politics of the issue as the deciding factor. On page 74, Grant Samuel makes the following statement:

“It is unclear what regulatory headwinds TCNZ (Telecom) would encounter when trying to compete with crown fibre holdings and its ultrafast broadband partners using its copper network other than to observe that the current adversarial and unsatisfactory regulatory environment would most likely prevail. It would be reasonable to conclude that the regulatory agencies are more likely to support the new Crown backed ultra fast broadband initiative to the detriment of the incumbent network provider.”

In other words, the government will simply tilt the playing field to make sure that ultimately it does prevail in any competitive situation.

This demerger by itself is no solution to Telecom’s ongoing problems of gradual market share erosion and continuing pressure on margins. The drive for efficiency contained in the Vision 2013 programme is beginning to make a difference on the cost structures, but has some way to go. The removal of the oppressive regulatory regime and costs associated with the whole demerger process should result in a worthwhile reduction in overheads going forward.

Unfortunately, there are no forward financial projections anywhere in the documentation. Investors will be aware that the financials have gradually trended down over the last several years, but have little to indicate whether this can be reversed following a demerger.

New Telecom retains a considerable wholesale capacity including the Southern Cross Cable, and 30 telephone exchanges in the main centres, which could have given Chorus greater opportunities for wholesale distribution and growth. The rationale for this is outlined in the documentation and is a combination of unregulated overseas assets and infrastructure specific to the existing back-haul capacity being retained.

Should the demerger not be approved, Telecom have already incurred approximately \$35m in direct costs and will be required to pay a further \$11m costs to Crown Fibre Holdings.

Other Risks and Uncertainty

The documents disclose a wide range of risks to investors of the demerger. Some specific issues need to be considered.

- For New Chorus, the biggest risk is that costs to implement the broadband rollout will escalate, without any way of increasing prices to offset this. In the first couple of years this will be moderated by the ability to charge connection costs to businesses connecting to fibre. Later free home connections will need to be funded, but by then the company expects revenue streams to be building sufficiently to offset the extra cost.

- There is no certainty regarding the rate of uptake of fast broadband. Repayments by New Chorus are accelerated if certain targets are not achieved. Overseas experience is of little assistance in estimating uptake as it varies dramatically. Offsetting this to some extent is the continuing revenue generated on the legacy copper service for those who do not make the change.
- Any liquidated damages mentioned in relation to delays and overruns on the ultra fast broadband contract, according to legal precedent, should be no greater than the actual losses incurred by the contracting party, and are not an unreasonable business risk.
- The Grant Samuel Report 7.6.3. makes it clear that New Chorus will hold a higher proportion of the current Telecom debt and be more highly geared than the current Telecom. The proforma accounts show a net interest expense of \$102m. We consider that this is manageable for an infrastructure company. However, the company will need to be cautious, as its ability to meet Crown fibre expectations depends on it retaining an investment grade status.
- New Chorus is also very dependent on New Telecom for its revenues. The pro forma accounts put this at 84%. However, the situation is less concerning than might be expected as New Telecom has little option where it buys network access. In any event, the price for a significant amount of new Chorus services will be regulated, reducing the ability for New Telecom to squeeze margins.
- New Telecom's risks are more related to commercial pressures. Following the demerger, it will be fully exposed to competition and will need to continue to reduce costs to achieve more acceptable returns. On the other hand, it will not have the regulatory burden to deal with and should be able to both innovate and react more appropriately in the market place. New Telecom does have the advantage of being either the dominant or second largest company in most areas of operations.
- As with all telecommunications companies, New Telecom is constantly being squeezed to provide more services for less cost. This trend is likely to continue and could impact future earnings.
- New Telecom needs to maintain an A band credit rating to retain the support of many of its larger shareholders. The conservative borrowings of \$750-\$950m, proforma net interest payments of \$38m and strong balance sheet make this highly likely.
- Neither the shareholders nor the two new companies should suffer taxation disadvantage from the separation. This has been the subject of binding rulings from the IRD and so we believe any risk is acceptable to shareholders.
- Telecom has estimated that the transaction costs of the separation will be between \$85m and \$120m of which \$35m have been incurred by the proposal even if defeated. We believe that these budget estimates could be understated, but are not so great as to negate the advantages of the separation

The rest include general economic risks such as currency and interest movements, management risks in the separation of formerly integrated operations, physical building risks over the ultra fast broadband cabling, government and regulatory risks, insurance, the cost of some ongoing litigation and financing risks with the lack of scale in smaller entities. Realistically, it is reasonable to conclude these risks are no greater than they would have been under a single entity. Fuller discussion of some of these issues is contained in section 2 of the investor documentation.

Conclusion

This is a negotiated settlement which arguably reflects the legacy of Telecom's past defensive tactics in the face of increasing competition, declining fixed line market, and government regulation coming home

to roost. However separation does reinstate the demerged Telecom companies as the taxpayers' partner in the most important communications network in the country, something that was close to slipping away a few months ago.

The Grant Samuel report sums up the reality on page 96 where it states:

“The evaluation of the proposed separation is largely subjective as the benefits are not all easily quantified or tested. There is no guarantee of future performance of either New Chorus or New Telecom. The issue for shareholders is whether the performance under the cooperate scenario is likely to be better relative to what it might be under the compete scenario.”

In our view, given the government’s ability to regulate to achieve a desired outcome (and the already demonstrated willingness of successive governments to do just that), there can be no doubt that the cooperate route is the best long term alternative.

Voting and Proxies

The shareholders meeting to decide on the demerger proposal will be held at Sky city, Auckland at 10am on 26th October 2011.

It is important that shareholders either vote, or send their proxy as a 75% majority is required. Free parking vouchers for Sky City are available at the meeting reception for those attending.

The New Zealand Shareholders Association is offering its usual proxy service to all share holders. They only need to put our name on the proxy form, tick the voting box or leave blank to give the NZSA a discretionary vote, sign it and send it to Computershare. Computershare must receive proxy forms by 10am on Tuesday 25th October 2011.

The New Zealand Shareholders Association will be voting undirected proxies that we hold IN FAVOUR of the demerger proposal.