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Analyst:

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Why Telstra Could be Worth Less than $2

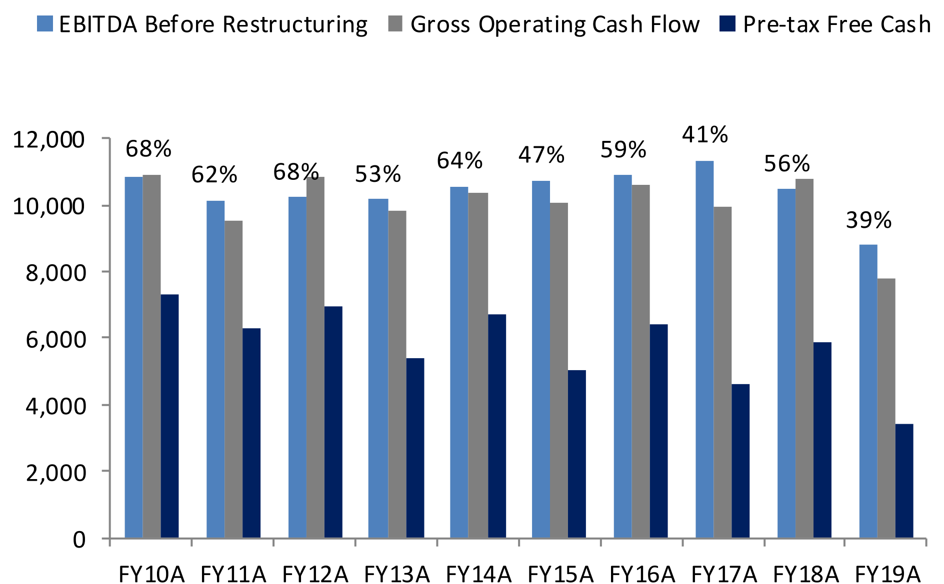
September 2019

We have discussed our Telstra investment view in earlier commentary and we don't believe much has changed in relation to our long-term expectations. However, the most recent result surprised in its complexity and is indicative of ***weak accounting, short termism and weak board oversight of management***. Critical elements of our thesis remain:

Telstra's earnings quality is poor…

1. ***EBITDA metrics being trumpeted by management are a poor proxy for cash flow*** and valuations based off this metric are fundamentally flawed. Merlon's preferred measure of intrinsic value is to compare a company's enterprise (or unleveraged) value with its sustainable enterprise-free-cash-flow.

Figure 1: Telstra EBITDA, Cash Flow & Cash Conversion



Source: Company Accounts, Cash flow includes cash receipts from asset sales to NBN Co and is net of benefit of $551m from "supply chain finance" in FY19 and benefit of "back-to-back" retail leases

2. **Retailing *NBN services will remain a loss leader*** for Telstra with current cost cutting initiatives destined to offset margin compression from the NBN transition rather than deliver absolute upside.

3. ***Mobile margins are high*** by historic standards and high relative to international peers.

…with the most recent result a case in point

Weak accounting in Telstra's most recent report add to our concerns and we see risk skewed to the lower end of our $1.80 and $4.50 valuation range. In particular we note (i) persistent references to EBITDA; (ii) unintelligible footnotes; (iii) "innovative" approaches to working capital management; and, (iv) an over-emphasis on earnings projections.

Excluding unsustainable fixed line earnings **Telstra's FY19 EPS was $0.09 to $0.12** which would yield valuations of $1.35 to $2.40 if capitalised at 15 to 20x.

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Introduction

Before calling out specifics of the most recent Telstra result, we thought it would be worthwhile highlighting a few comments made in Berkshire Hathaway's 2002 annual report.

"There is seldom just one cockroach in the kitchen"

Figure 2: Extract from Berkshire Hathaway's 2002 Annual Report (emphasis added)

Three suggestions for investors: First, beware of companies displaying weak accounting. If a company still does not expense options, or if its pension assumptions are fanciful, watch out. When managements take the low road in aspects that are visible, it is likely they are following a similar path behind the scenes. There is seldom just one cockroach in the kitchen.

Trumpeting EBITDA (earnings before interest, taxes, depreciation and amortization) is a particularly pernicious practice. Doing so implies that depreciation is not truly an expense, given that it is a "non-cash" charge. That's nonsense. In truth, depreciation is a particularly unattractive expense because the cash outlay it represents is paid up front, before the asset acquired has delivered any benefits to the business. Imagine, if you will, that at the beginning of this year a company paid all of its employees for the next ten years of their service (in the way they would lay out cash for a fixed asset to be useful for ten years). In the following nine years, compensation would be a "non-cash" expense – a reduction of a prepaid compensation asset established this year. Would anyone care to argue that the recording of the expense in years two through ten would be simply a bookkeeping formality?

Second, unintelligible footnotes usually indicate untrustworthy management. If you can't understand a footnote or other managerial explanation, it's usually because the CEO doesn't want you to. Enron's descriptions of certain transactions *still* baffle me.

Finally, be suspicious of companies that trumpet earnings projections and growth expectations. Businesses seldom operate in a tranquil, no-surprise environment, and earnings simply don't advance smoothly (except, of course, in the offering books of investment bankers).

Source: Berkshire Hathaway 2002 Annual Report (http://www.berkshirehathaway.com/2002ar/2002ar.pdf)

In particular, Buffet shares our cynicism about (i) "EBITDA" as a measure of value (we focus on free-cash-flow); (ii) complex accounts (free-cash-flow is more difficult to manipulate); and (iii) short term earnings projections (we take a long-term mid-cycle view).

We examine Telstra against this backdrop.

Trumpeting EBITDA is a particularly pernicious practice

Buffet's first suggestion is to beware of companies displaying weak accounting. This suggestion is an absolute foundation of the Merlon investment process that unwaveringly focuses on free-cash-flow not accounting earnings or asset values as the primary driver of valuation.

The Telstra financial report for the year to June 2019 made 71 references to the acronym "EBITDA"; the notes to Telstra's result presentation made 62 references; while the transcript from the results briefing made 49 appearances. The presentation itself made at least 35 more references to EBITDA in as many slides but these could not be counted electronically so this should be treated as a conservative estimate.

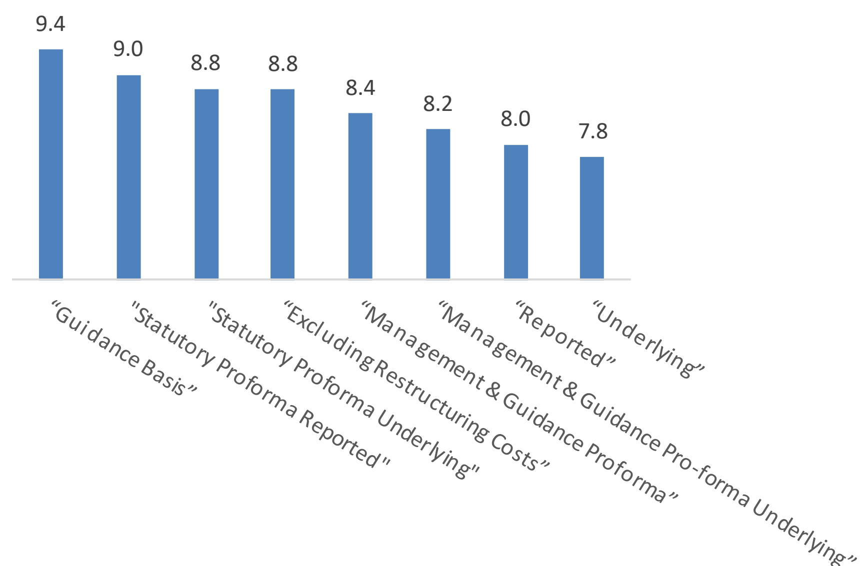
If this doesn't fit Buffet's definition of "trumpeting EBITDA" then we're not sure does. Telstra's result includes (at least) 8 categories of EBITDA:

The Telstra result includes 8 categories of EBITDA…

- "EBITDA excluding restructuring costs";
- "Underlying EBITDA";
- "Guidance Basis EBITDA";
- "Reported EBITDA";
- "Statutory Proforma Underlying EBITDA";
- "Statutory Proforma Reported EBITDA";
- "Management & Guidance Proforma EBITDA"; and, our favourite,
- "Management & Guidance Pro-forma Underlying EBITDA"

These definitions range from $7.8 billion at the low end to $9.4 billion at the high end.

Figure 3: Telstra FY19 "EBITDA" As Reported in Result Presentation (A$b)



Source: Company Presentation

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Ignore the cash flow statement at your peril

A useful distraction from actually analysing the business and the industry…

It is easy to spend hours and hours trying to reconcile the various definitions of EBITDA. It is scary to contemplate the aggregate number of hours spent by security analysts working through this exercise across the investment community at large. This provides a useful distraction from actually analysing the trends in the business and the industry.

At Merlon, our focus is on the cash flow statement rather than measures of "advertised" earnings. Listed companies do a good job singing the virtues of such advertised metrics often with advisers, brokers, analysts, journalists and other commentators cheering on from the sidelines. Often these advertised metrics form the basis for variable remuneration prompting management and board members to join the chorus.

As we persistently highlight, management teams and boards are becoming ever increasingly creative about how they define profitability. Some of the measures highlighted above are examples of this. "Management & Guidance Pro-forma Underlying EBITDA" is yet again not a measure of profitability defined in any accounting textbook.

Non-statutory measures of performance are easily manipulated…

The bottom line is that management teams can define profitability however they choose but can't as easily hide from the realities of the cash flow statement. Every 6 months we work through the gruelling process of trying to reconcile Telstra's various definitions of "EBITDA" to the company's statutory cashflow statement.

Eventually realities come home to roost and when this happens stocks with low earnings quality tend to underperform.

Earnings are opinion; cash is fact; but not always

To Telstra's credit, the company has partially graduated from EBITDA to measures of cash flow. Having said that, nothing is simple when it comes to Telstra and the company's definition of "free cash flow" differs from our own. Managements and boards are increasingly finding ways to distort cash flow statements. This is deeply concerning to us.

…and unfortunately so is the cash-flow statement.

An example of this is Telstra's cash flow which may be misleading through the increased use of "reverse factoring". Among the dozen or so highly paid sell side analysts covering the stock, it took Martin Lawrence from independent governance adviser Ownership Matters to publish research on this issue.

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"supply chain finance" boosted Telstra's cash flow by $551m…

Figure 4: Extract from Testra's 2019 Financial Report (emphasis added)

From time to time, Telstra's suppliers utilise supply chain finance, i.e. they transfer their rights of the amounts due from Telstra to third parties. However, Telstra's obligation is to pay for goods and services purchased from our suppliers on the original due date without any change in payment terms. As at 30 June 2019, the amount payable under this arrangement was $593 million (2018: $42 million) and we have reclassified it from 'Trade payables' to 'Other payables'.

Source: Telstra 2019 Financial Report (https://www.asx.com.au/asxpdf/20190815/pdf/447hcwytc63l76.pdf)

The implication of the disclosure above is that the increase in usage of "supply chain finance" boosted Telstra's cash flow by $551 million for the year.

2019 was not the first year Telstra's cash flow benefited from "innovative" working capital management schemes. In 2018 Telstra called out "improving working capital initiatives including Go Mobile Swap leasing."

And prior periods were impacted by "back-to-back" mobile leases…

Figure 5: Extract from Testra's 2019 Financial Report (emphasis added)

We also lease handsets which we then sublease to our retail customers in a back-to-back arrangement.

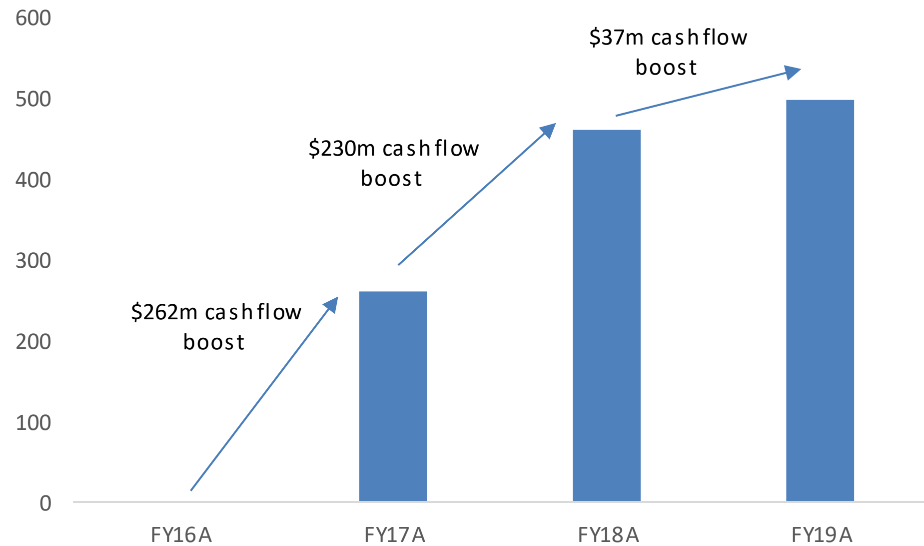
Table D sets out our future minimum lease receivables from retail customers under non-cancellable operating leases (Telstra as lessor).

Table D Telstra Group	As at 30 June 2019 $m	2018 $m
Within 1 year	380	332
Within 1 to 5 years	119	130
	499	**462**

Source: Telstra 2019 Financial Report (https://www.asx.com.au/asxpdf/20190815/pdf/447hcwytc63l76.pdf)

The implication of this disclosure is that this "back-to-back arrangement" boosted Telstra's cash flow by $37 million. The real action, however, was in 2017 and 2018 where these arrangements boosted cash flow by around $500m over two years.

Figure 6: Telstra minimum lease receivables from retail customers



Source: Company Accounts

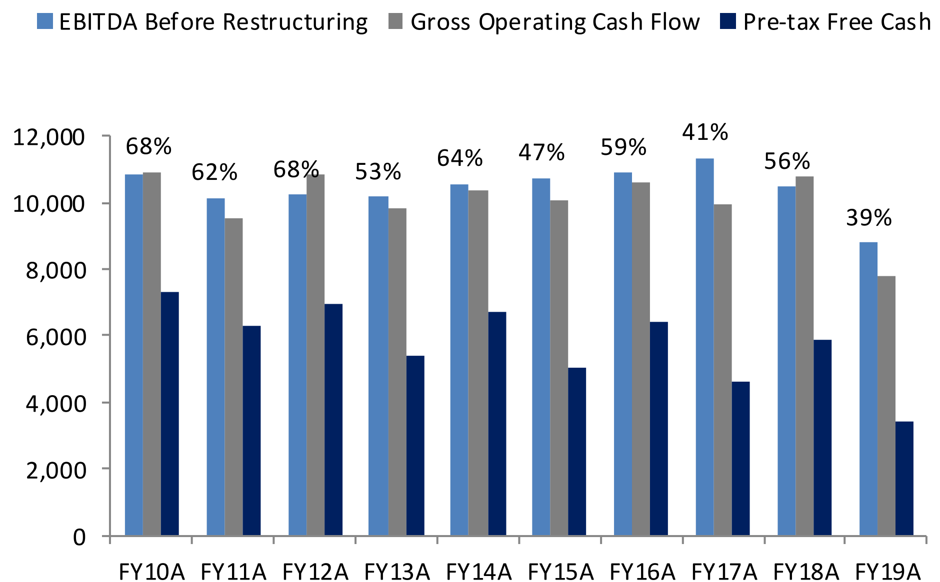
The timing of Telstra's decision to stop selling mobile lease plans is curious…

The timing of Telstra's decision to stop selling mobile lease plans in June 2019 is curious. The decision coincides with the introduction of AASB16 which requires mobile leases be recognised as a liability on the company's balance sheet. Telstra have stated that 2020 cash flow will be impacted by "*a significant working capital increase of approximately $1 billion, driven predominantly from the exit of our mobile lease plans*"

It seems the new accounting standards for operating leases have thwarted the cosmetic appeal of the "back-to-back" lease arrangement and led Telstra to revert to a more conventional approach of carrying receivables on its own balance sheet.

Taking these adjustments into account, Telstra's earnings quality is poor with the company converting just 39% of its financial year 2019 "EBITDA Before Restructuring" into pre-tax cash flow.

Figure 7: Telstra EBITDA, Cash Flow & Cash Conversion



Source: Company Accounts, Cash flow includes cash receipts from asset sales to NBN Co and is net of benefit of $551 from "supply chain finance" in FY19 and benefit of "back-to-back" retail leases in FY17 & FY18

Telstra's earnings quality is poor…

People Respond to Incentives

"Most of economics can be summarized in four words: "People respond to incentives." The rest is commentary."

— Steven E. Landsburg, Armchair Economist: Economics And Everyday Experience

Management respond to incentives set by the board…

The "EBITDA Before Restructuring" set by the board for the purposes of determining management remuneration was $9.2 billion. A cursory glance at the various definitions of EBITDA included in Figure 3 highlights that this target was missed by all but one of the measures disclosed in the result presentation including the measure upon which the target was supposed to be based.

…and boards appear flexible in relation to how performance is measured.

That said, the board took it upon itself to create a ninth definition of EBITDA "for the purpose of the EVP [Executive Variable Remuneration Plan] performance measure. This figure came in at $9.1 billion but only after adding back more restructuring than initially envisaged ($0.8 billion vs $0.6 billion) and more software write-downs than initially envisaged ($0.5 billion vs nil).

The inclusion of "Free Cash Flow" in as an EVP performance measure may also explain the company's "innovative" approaches to working capital discussed earlier.

Unintelligible footnotes indicate untrustworthy management

If you can't understand a footnote it's usually because the CEO doesn't want you to…

Buffet's second suggestion is that if you can't understand a footnote its usually because the CEO doesn't want you to. On that front, Telstra's result presentation is littered with footnotes. Remember that the presentation is meant to summarise the company's results. Overleaf are some of the footnotes from Telstra's result presentation.

Even something as seemingly simple as explaining how Telstra arrived at its 16 cent per share dividend appears wrought with complexity. This is a big issue for a company with such a large retail shareholder base who rely on dividend yield as a key measure of valuation.

Figure 8: Telstra Explanation of Decision to pay 16 Cent Dividend

Group results: dividends

	FY18	FY19	CHANGE
Earnings per share			
Basic earnings per share (cents)	30.2	18.1	-40.1%
Underlying basic earnings per share (cents)[1]	21.7	17.0	-21.7%
Dividends (fully-franked)			
Ordinary dividend	15.0	10.0	-33.3%
Special dividend	7.0	6.0	-14.3%
Total dividends	**22.0**	**16.0**	**-27.3%**
Payout Ratios[3]			
Ordinary dividend of underlying earnings[3]	69%	59%	
Special dividend of net one-off nbn receipts	65%	63%	
Total dividends of earnings per share[3]	**73%**	**88%**	

FY19 total dividends of 16 cents per share (cps) fully franked, including total ordinary dividends of 10cps and total special dividends of 6cps

Final dividend of 8cps fully franked, including ordinary dividend of 5cps and special dividend of 3cps

2H19 dividends consistent with 1H19

FY19 ordinary dividend payout of underlying[1] earnings[1,2] below indicative 70% to 90% range with the board taking into account capital management framework

64% of cumulative net one-off nbn™ receipts received life to date[4] returned via fully-franked special dividends[1,2]

Overall FY19 dividend payout ratio of 88%

Underlying earnings excludes restructuring costs, impairments and guidance adjustments as well as net one-off nbn receipts[1]

Remain committed to capital management framework including maintaining balance sheet settings consistent with an A band credit rating

1. Underlying earnings is defined as NPAT from continuing operations excluding net one-off nbn receipts and guidance adjustments. Guidance adjustments include one-off restructuring costs, impairments in and to investments or property, plant and equipment and intangible assets, proceeds on the sale of businesses, mergers and acquisitions and purchase of spectrum. "net one-off nbn receipts" is defined as net nbn one off Definitive Agreement receipts (consisting of PSAA, Infrastructure Ownership and Retraining) less nbn net cost to connect less tax. FY19 underlying earnings were $2,019m (FY18 $2,582m), net one-off nbn DA receipts less nbn net C2C less tax were $1,129m (FY18 $1,285m), and total guidance adjustments less tax and non-controlling interest were -$994m (FY18 -$276m).
2. The dividend is subject to no unexpected material events, and is subject to Board discretion having regard to financial and market conditions, business needs and maintenance of financial strength and flexibility consistent with Telstra's capital management framework.
3. FY18 payout ratios have been restated consistent with restatement of earnings based on AASB15 and underlying earnings definition. Ordinary dividend payout ratio including guidance adjustments was 116% in FY19 (77% FY18).
4. "Life to date" defined as since beginning FY18 and implementation of new dividend policy with restated earnings based on AASB15.

Source: Telstra FY19 Result Presentation

Figure 9: Selected Footnotes from Telstra's FY19 Result Presentation

1. This guidance assumed wholesale product price stability and no impairments to investments or core assets, and excluded any proceeds on the sale of businesses, mergers and acquisitions and purchase of spectrum. The guidance also assumed the nbn™ rollout and migration in FY19 was broadly in accordance with the nbn Corporate Plan 2019. The guidance was provided on the basis of AASB15. Capex was measured on an accrued basis and excluded expenditure on spectrum and externally funded capex.
2. Total income excludes finance income.
3. Underlying EBITDA excludes one-off nbn DA receipts less nbn net C2C, and guidance adjustments.
4. In-year nbn headwind defined as the net negative recurring EBITDA impact on our business based on management best estimates.
5. Total dividends of 16 cents per share fully franked comprising total ordinary dividend of 10 cents per share and total special dividend of 6 cents per share.

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1. This guidance assumed wholesale product price stability and no impairments to investments or core assets, and excluded any proceeds on the sale of businesses, mergers and acquisitions and purchase of spectrum. The guidance also assumed the nbn™ rollout and migration in FY19 was broadly in accordance with the nbn Corporate Plan 2019. The guidance was provided on the basis of AASB15.
2. Total income excludes finance income.

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1. Fixed excludes one-off nbn connection income FY19 $106m (FY18 $113m) and includes TUSOPA income FY19 $159m (FY18 $167m). One-off nbn connection income included in one-off nbn DA and connection.
2. Recurring nbn DA restated to include ISA power.
3. Global connectivity includes other income FY19 $5m (FY18 $15m).
4. Other includes media, nbn commercial works (sale of assets), M&A, and miscellaneous.
5. New business includes Telstra Health and Ooyala.
6. Refer to Full Year Results and Operations Review – guidance versus reported results reconciliation schedule.

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1. Restated due to accounting changes and review of fixed costs - underlying and other inclusions. Sales and fixed costs exclude costs associated with one-off nbn DA and nbn cost to connect (C2C).
2. Fixed costs - underlying was ~$8.3b in FY16 and targeted to decline by our net cost productivity target of $2.5b by FY22.
3. Fixed costs - other includes items supporting revenue growth including relevant NAS costs, mobile lease, and product impairment.
4. Refer to Full Year Results and Operations Review – guidance versus reported results reconciliation schedule

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1. Product EBITDA restated due to accounting changes and review of fixed cost allocation methodologies to products. Mobile & fixed restated to include International network costs previously included in Other.
2. Fixed includes TUSOPA income FY19 $159m (FY18 $167m).
3. Fixed excludes one-off nbn C2C net of connection income FY19 $362m (FY18 $284m) represented against net one-off nbn DA less net C2C. This includes one-off nbn connection income FY19 $106m (FY18 $113m) and one-off nbn cost to connect (C2C) FY19 $468m (FY18 $397m).
4. Other includes media, nbn commercial works (sale of assets), and miscellaneous.
5. New business includes Telstra Health and Ooyala.
6. Refer to Full Year Results and Operations Review – guidance versus reported results reconciliation schedule.

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1. Working capital movement from operating activities.
2. Includes net investments, interest received, proceeds from lease assets, proceeds on disposal, and non-cash EBITDA items (including impairments and gain on disposal of PP&E).
3. Refer to Full Year Results and Operations Review – guidance versus reported results reconciliation schedule. Guidance adjustments include M&A disposals and spectrum.
4. This guidance assumed wholesale product price stability and no impairments to investments or core assets, and excluded any proceeds on the sale of businesses, mergers and acquisitions and purchase of spectrum. The guidance also assumed the nbn™ rollout and migration in FY19 was broadly in accordance with the nbn Corporate Plan 2019. The guidance was provided on the basis of AASB15.Capex was measured on an accrued basis and excluded expenditure on spectrum and externally funded capex.
5. Capex is measured on an accrued basis and excludes expenditure on spectrum and externally funded capex and capitalised leases under AASB16 leases.

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1. Underlying earnings is defined as NPAT from continuing operations excluding net one-off nbn receipts and guidance adjustments. Guidance adjustments include one-off restructuring costs, impairments in and to investments or property, plant and equipment and intangible assets, proceeds on the sale of businesses, mergers and acquisitions and purchase of spectrum. "net one-off nbn receipts" is defined as net nbn one off Definitive Agreement receipts (consisting of PSAA, Infrastructure Ownership and Retraining) less nbn net cost to connect less tax. FY19 underlying earnings were $2,019m (FY18 $2,582m), net one-off nbn DA receipts less nbn net C2C less tax were $1,129m (FY18 $1,285m), and total guidance adjustments less tax and non-controlling interest were -$994m (FY18 -$276m).
2. The dividend is subject to no unexpected material events, and is subject to Board discretion having regard to financial and market conditions, business needs and maintenance of financial strength and flexibility consistent with Telstra's capital management framework.
3. FY18 payout ratios have been restated consistent with restatement of earnings based on AASB15 and underlying earnings definition. Ordinary dividend payout ratio including guidance adjustments was 116% in FY19 (77% FY18).
4. "Life to date" defined as since beginning FY18 and implementation of new dividend policy with restated earnings based on AASB15.

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1. Represents position after hedging based on accounting carrying values. Gross debt comprises borrowings and derivatives.
2. Represents gross interest cost on gross debt.
3. Debt servicing calculated as net debt over EBITDA. Gearing calculated as net debt over total net debt and equity. Interest cover calculated as EBITDA over net interest expense (excluding capitalised interest and revaluation impacts on our borrowings and derivatives).
4. Capex was measured on an accrued basis and excluded expenditure on spectrum and externally funded capex.
5. ROE is calculated at PATMI as a percentage of equity.
6. ROIC calculated as NOPAT as a percentage of total capital. Underlying ROIC calculated as NOPAT excluding net one-off nbn DA less C2C and guidance adjustments less tax as a percentage of total capital. Guidance adjustments include one-off restructuring costs, impairments in and to investments or property, plant and equipment and intangible assets, proceeds on the sale of businesses, mergers and acquisitions and purchase of spectrum. Historical numbers restated based on updated definition and - underlying ROIC including guidance adjustments 5.0% (FY18 9.1%)
7. This estimate is illustrative only and actual impacts will depend on final accounting interpretations and assumptions. See 'AASB16 "leases" FY19 Proforma & FY20 indicative impacts" slide
8. Post-nbn defined as FY23 and beyond on AASB16 basis

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1. Impacts shown are based on a projection of current lease portfolios and provided to give a directional sense of the quantum. Actual impacts may differ from numbers shown.
2. Refer to Full Year Results and Operations Review – guidance versus reported results reconciliation schedule.
3. Finance costs also relate to mobile swap.
4. This estimate is illustrative only and actual impacts will depend on final accounting interpretations and assumptions

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1. This guidance assumes wholesale product price stability and no impairments in and to investments or property, plant and equipment and intangible assets, and excludes any proceeds on the sale of businesses, mergers and acquisitions and purchase of spectrum. The guidance also assumes the nbn rollout and migration in FY20 is broadly in accordance with the nbn Corporate Plan 2019. Guidance is provided on the basis of AASB16 Leases and assumes impacts consistent with management estimates and current interpretation of the standard. Capex is measured on an accrued basis and excludes expenditure on spectrum and externally funded capex and capitalised leases under AASB16 Leases.
2. Excluding finance income.
3. Underlying EBITDA excludes net one-off nbn DA receipts less nbn net C2C, guidance adjustments and includes amortisation of mobile operating lease costs.
4. In-year nbn headwind defined as the net negative recurring EBITDA impact on our business based on management best estimates including key input of the nbn Corporate Plan 2019.
5. FY20 free cashflow defined as operating cash flows less investing cash flows less operating leases (reported in financing cash flow under AASB16 Leases).
6. FY20 free cashflow guidance includes ~$1b working capital increase including from exit of mobile lease plans, remaining outflows from restructuring costs announced in May 2019, and an increase in nbn receivables

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1. Underlying earnings is defined as NPAT from continuing operations excluding net one-off nbn receipts (as defined in footnote 2) and guidance adjustments.Guidance adjustments include one-off restructuring costs, impairments in and to investments or property, plant and equipment and intangible assets, proceeds on the sale of businesses, mergers and acquisitions and purchase of spectrum.
2. "net one-off nbn receipts" is defined as net nbn one off Definitive Agreement receipts (consisting of PSAA, Infrastructure Ownership and Retraining) less nbn net cost to connect less tax.
3. The dividend is subject to no unexpected material events, and is subject to Board discretion having regard to financial and market conditions, business needs and maintenance of financial strength and flexibility consistent with Telstra's capital management framework.
4. Capex is measured on an accrued basis and excludes expenditure on spectrum and externally funded capexand capitalised leases under AASB16 Leases.

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1. Product operating expenses restated due to accounting changes and review of fixed cost allocation methodologies to products.
2. Fixed excludes one-off nbn cost to connect (C2C) FY19 $468m (FY18 $397m). One-off nbn C2C included in one-off nbn DA and nbn C2C.
3. Recurring nbn DA restated to include ISA power.
4. Other includes media, nbn commercial works (sale of assets), and miscellaneous.
5. New business includes Telstra Health and Ooyala.
6. Refer to Full Year Results and Operations Review – guidance versus reported results reconciliation schedule.

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1. TUSOPA is run by Department of Communications and the Arts and the income is net of the levy paid.
2. Included as sales revenue. Restated to include ISA power.
3. Included as other income.
4. Included as other income. Includes receipts for assets transferred under the nbn Definitive Agreements (DAs). Restated to exclude ISA power.
5. included as other income. Includes income from nbn disconnection fees (Per Subscriber Address Amount (PSAA)).
6. nbn commercial works – products and services revenue is recognised as NAS revenue.

Source: Telstra FY19 Result Presentation

Be Suspicious of Earnings Projections

Despite Buffet's suspicions about earnings projections, no Telstra result presentation would be complete without guidance. And no Telstra guidance would be complete without an updated definition of "Underlying EBITDA" ("includes amortisation of mobile leasing costs") and without six accompanying footnotes. Whether these footnotes meet Buffet's criteria of "unintelligible" we will leave to our readers' discretion.

Earnings simply don't advance as smoothly as guidance implies…

Figure 10: Telstra 2020 Analyst Guidance

FY20 guidance

	FY19	FY20 guidance[1] Based on new accounting standards
Total income[2]	$27.8b	$25.7b to $27.7b
Underlying EBITDA[3] - Included in-year nbn headwind[4]	**$8.2b**	**$7.3b to $7.8b** ~-$0.8 to ~-$1.0b
Net one-off nbn DA receipts less nbn net C2C	$1.6b	$1.6b to $2.0b
Restructuring costs	$0.8b	~$0.3b
Capex	**$4.1b**	**$2.9b to $3.3b**
Free cashflow after operating lease payments[5,6]	**$3.1b**	**$3.4b to $3.9b**

	Range	
FY20 Underlying EBITDA movement	-$0.9b	-$0.4b
Excluding approximate in-year nbn headwind	$0.9b	$0.9b
Growth ex-nbn headwind	$0b	+$0.5b

1. This guidance assumes wholesale product price stability and no impairments in and to investments or property, plant and equipment and intangible assets, and excludes any proceeds on the sale of businesses, mergers and acquisitions and purchase of spectrum. The guidance also assumes the nbn rollout and migration in FY20 is broadly in accordance with the nbn Corporate Plan 2019. Guidance is provided on the basis of AASB16 Leases and assumes impacts consistent with management estimates and current interpretation of the standard. Capex is measured on an accrued basis and excludes expenditure on spectrum and externally funded capex and capitalised leases under AASB16 Leases.
2. Excluding finance income.
3. Underlying EBITDA excludes net one-off nbn DA receipts less nbn net C2C, guidance adjustments and includes amortisation of mobile operating lease costs.
4. In-year nbn headwind defined as the net negative recurring EBITDA impact on our business based on management best estimates including key input of the nbn Corporate Plan 2019.
5. FY20 free cashflow defined as operating cash flows less investing cash flows less operating leases (reported in financing cash flow under AASB16 Leases).
6. FY20 free cashflow guidance includes ~$1b working capital increase including from exit of mobile lease plans, remaining outflows from restructuring costs announced in May 2019, and an increase in nbn receivables

Source: Telstra FY19 Result Presentation

While the presence of such "Guidance" is hardly surprising, it is remarkable the extent to which the market relies upon it in forming expectations. One analyst report commented that "Overall, Telstra tends to be conservative in setting guidance" notwithstanding the fact that the company missed its 2019 EBITDA guidance on all but one the eight categories reported and missed its 2019 free cash flow guidance notwithstanding "innovative" working capital management initiatives.

Is Telstra a Good Investment?

We have discussed our investment view in earlier commentary and we don't believe much has changed in relation to our long-term expectations. Critical elements of our thesis remain:

1. ***EBITDA metrics being trumpeted by management are a poor proxy for cash flow.*** and valuations based off this metric are fundamentally flawed.

2. ***Reselling NBN services will remain a loss leader*** for Telstra with current cost cutting initiatives serving to offset margin compression from the NBN transition rather than deliver absolute upside.

3. ***Mobile margins are high*** by historic standards and high relative to international peers.

How to Value Telstra?

Merlon's preferred measure of intrinsic value is to compare a company's enterprise (or unleveraged) value with its sustainable enterprise-free-cash-flow. In the case of Telstra this approach gives rise to a valuation range of between $1.80 and $4.50. Our view is that risks are skewed towards the lower end of this range.

Telstra is more financially leveraged, lower growth, more capital intensive and has lower earnings quality than the market at large…

Taking a more simplistic approach to valuation yields the same conclusion. In particular we note that:

- Telstra just reported "Underlying basic earnings per share" of 17 cents;

- Telstra's fixed line business just reported "Underlying EBITDA" of $1,406 million which on after tax basis represents approximately 8 cents per share. This amount, in our view, is trending towards zero;

- Telstra is more financially leveraged, lower growth, more capital intensive and has lower earnings quality than the market at large warranting a below market earnings multiple.

Excluding unsustainable fixed line profits, Telstra's EPS looks closer to 9-12 cents…

Figure 11: Implied Telstra Valuation Based on Simple Price / Earnings Ratio

	Low	High
FY19 underlying basic earnings per share	**$0.17**	**$0.17**
Less: Fixed line contribution	($0.08)	($0.05)
FY19 EPS excluding fixed line	**$0.09**	**$0.12**
Price/Earnings ratio	15x	20x
Implied valuation based on simple price/earnings ratio	**$1.35**	**$2.40**

Source: Company 2019 full year result presentation, Merlon Capital Partners

We do not hold Telstra shares in our portfolios.

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