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The Manager

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Dear Sir or Madam

JP Morgan TMT Conference, 15 May 2018 – Transcript

In accordance with the Listing Rules, I attach a copy of the CEO transcript from Andrew Penn's presentation and Q&A at the JP Morgan Global Technology, Media and Communications Conference in Boston this week, for release to the market.

Yours faithfully

Sue Laver
Company Secretary

[Eric Pan, JP Morgan] Thanks for joining us. For those who don't know me I am the Australian TMT analyst for JP Morgan and I'd like to welcome Andy Penn CEO of Telstra to the conference. Andy has been in the CEO seat for three years and three years before that he was the CFO. So Andy I think I believe you have some introductory remarks that you'd like to make.

[Andrew Penn, CEO Telstra] Thanks very much Eric for the opportunity to be here and thank you for joining us this morning. I thought I'd make some high level comments and then I think we're going to go to some Q&A. But I think as you'll see across the conference there's no doubt that we're at a critical time in the global telecommunications industry. On the one hand demand for our core products and services has never been greater. We've seen data grow at 50 percent per annum and clearly telecommunications networks have become one of, if not the most important piece of critical infrastructure around the world. And we're only going to see that continuing to increase as we move to the next wave of technology innovation in the next platform of technology which will clearly be as we move to 5G.

But it's not just about 5G. It's when you take 5G in conjunction with software defined networking, NFV and also in conjunction with innovation in compute technology around machine learning, data science etc. that I believe that this next transition will be more profound than from a technology point of view than any other one previously. And the crucial question for telcos is can telcos capture more of the value that is created which will be undoubtedly created by 5G. But can telcos capture more of that value than they have been typically able to do through previous generations and technology innovation and transition. And that's very much sits at the heart of our strategy which is where we are building the capabilities to move us from not just being the traditional expert in network and electrical engineering, which we clearly are and we will continue to be, but increasingly these days in building a telecommunications network, you need new capabilities in software engineering as well as we build out these new platforms, and also to be able to take advantage of potentially the value that is created above the level of the network which we have been able to successfully do through our Network Application Services business.

So I for one remain optimistic about the long term of the industry, but as an industry we have to get that transition right and we have to be investing in the capabilities that we haven't traditionally necessarily had and that's exactly what we've been doing.

At the same time however there's no doubt that the competitive intensity in the Australian market has increased substantially. We have a particularly unique dynamic in the Australian market called the National Broadband Network which we can go into in more detail if need be. But the point is, is that that is the origin of many of the challenging competitive dynamics that we see in the market today. We're seeing more entrants coming in as re-sellers of the nbn. We're seeing wholesale prices more than double as a retailer of fixed networks which is now what Telstra needs to become and is. And at the same time we are seeing a fourth entrant come into the mobile market and that's all creating a very significant and intense competitive environment which is having a short term impact on effectively, certainly for Telstra on our ARPUs and we provided a market update earlier in the week where we highlighted that our ARPUs were down about 3.6% on mobile and 2.4% on fixed in the second half of the year.

So a very competitive environment right now. And we've been doing a lot to respond to that. We launched Belong which is a flanker brand. We've gone into unlimited. We implemented a number of initiatives and we can talk more about those Eric in terms of how your guests want to take the conversation, but clearly challenging in the short term.

So in summary for me, I'm very optimistic about the long term, we're putting in place the right investments with the right strategy. But clearly the competitive environment at the moment is very challenging and we're responding to that and encouragingly and most importantly we are continuing to grow our customer numbers, and in fact if anything in the last quarter saw an acceleration in our growth in customer numbers which is critical that we win in this market.

So happy to hand back to you Eric and take any questions.

[Eric Pan] Great, so there are a lot of points mentioned that I want to hit on, but first on that on the 3Q trading update issued on Monday, the headwinds that were mentioned by Warwick your CFO on the conference call yesterday were not particularly new. So what's changed over the past three to four months that warranted the guidance downgrade?

[Andrew Penn] Yeah look I think look the underlying trends are not new, it's just I guess the extent of their intensity that has increased. And we've definitely seen a significant step down in ARPUs in the industry from a fixed perspective. One of the big competitors in the market basically reduced their hero product to $60 unlimited on fixed. I think that was around about November December. And then we've also seen increased intensity on the mobile side. And you will have seen that basically ourselves and Voda, which is the third competitor in mobiles, announced unlimited plans as well very recently. And the bottom line though is that we from Telstra's perspective what we've been seeing is that an our underlying minimum monthly contribution, which is essentially the weighted average of the plan sizes that we sell, has encouragingly continue to grow, but the out of bundle charges that we receive for data in particular has obviously declined. And we've also seen increased competition in handset subsidies as well.

[Eric Pan] Great. There has been an explosion in data inclusion in Australia over the last year in the marketplace. One worry for investors is that, you know, customers stepping down in plans as a result of the increase in data inclusion not being matched by the increase in data usage. Are you seeing any of that step down in terms of plans for consumers?

[Andrew Penn] No, not so much which really goes to the point about minimum monthly contribution. So that's effectively, the MMC is what we refer to, is essentially the weighted average of the plan size that customer's take with us, and we measure it for Joiners, Leavers and Stayers. And so the point is is that our MMC has continued to increase, so the weighted average of the plan size that customers are taking is increasing which suggests that your point there about customers stepping down in plan size is not happening, or at least to any significant degree for us. But what is happening is that the bundle, the data bundles, have at least tripled over the last 12 months and so that is growing at a rate which is faster than the underlying data used and so therefore the out of bundle revenues have therefore been hit.

[Eric Pan] Right. And how should we think about the potential impact on network utilisation and operating costs from this increase in data inclusions?

[Andrew Penn] Well it's not so much an impact on operating costs. It potentially impacts capex if it encourages greater data usage and clearly unlimited will drive greater data usage and we follow very closely what's happened here in the U.S. with the U.S. market went to unlimited back in 2016. But the biggest impact is obviously on out of bundle prices or out of bundle charges essentially. So when customers currently, if they go over their data allowance, they will buy an additional pack for data. They pay ten dollars and get another Gig or they'll pay an excess data charge. Obviously those charges will disappear in a world where either the data buckets, rather, are increasing greater than the actual rate of usage or where the market, or if the market goes completely to unlimited.

[Eric Pan] Gotcha. And as mentioned in your intro, you know we have a potential fourth entrant in mobile coming into the market. How do you plan on responding to the threat of a new entrant and what can you do in advance before they come in?

[Andrew Penn] Well we've launched a number of initiatives and I think we talked a little bit about unlimited. Another important initiative for us has been the launch of Belong which is our second brand. We launched Belong in the fixed market about four years ago, that's been very successful. Telstra is a premium player in the market. We invest considerably in making sure that we have the best network in the country. We have the most coverage, the fastest network and provide the best network experience for our customers. We've just won for the third survey in a row the Netflix speeds for basically for media and content, so we are premium in terms of that. Also in terms of our media inclusions and our service and the way in which we support our customers and what's critical for us is that what we don't do is we don't take a premium brand and then price that in the price sensitive market against a player which is not offering those premium services and so that's why launching Belong as a flanker brand to look at a different target market, a more price sensitive market and a market which is perhaps less concerned about the sorts of characteristics of network quality that I've talked about, less concerned about media inclusions and actually position that to compete with other players in that sector including the new entrant rather than take the Telstra brand down to that position.

[Eric Pan] Gotcha. And you guys announced an unlimited offer earlier this month and then TPG, the potential new entrant, announced their version which is significantly cheaper at $10 a month. What do you think their ultimate strategy is? Because when I do the math you can't make money on ten dollars a month.

[Andrew Penn] Yeah look, I always am I'm very cautious about commenting on competitor's strategy. I mean the first thing I should say is that I treat every competitor very, very credibly and TPG is a credible competitor. They've built a very successful business in the fixed market. I'm not aware of exactly what their launch plans are, beyond that which I've read through statements that they've made or through media that have commentated on it as well. And like you I've seen the announcement of the intended mobile plans but to my knowledge the network, they haven't launched their network yet and it's not clear to me when they are going to launch their network. Obviously it's a very aggressive price point and I'm sure you know in the early stages that's clearly about trying to achieve scale and get customers onto their network. But I think we'll just obviously have to see what the network actually looks like when it is launched and I understand it's intended to be later this year but I don't have any more information on that than you than you do. But in the meantime that's why we have been focusing on these other initiatives ourselves, being ahead of the market on unlimited when it was clear to me that the market was going to go there we wanted to be first so we were first above the line with unlimited, as I say rolling out the flanker brand that we've talked about, we've built out our media portfolio even further we've launched Foxtel Now, we just bought the rights on soccer in addition to the rights on Australian Rules football and rugby, so we have by far the best media offering as well and so that's where we've been focusing our strategy.

[Eric Pan] Right. Speaking of Foxtel Now and soccer, your primary competitor Optus has positioned itself as the place to go for exclusive soccer content with the EPL and the World Cup. Do you foresee Telstra going down the same path of bundling? Your mantra has been offering the customer more for more. How do you see the potential for offering a double play, triple play, even quad play in Australia?

[Andrew Penn] Sure, we currently, in our fixed portfolio probably close to 40 percent of our customers are in some form of entertainment bundle. So we offer that today and that's right the way across the spectrum from premium Foxtel offering, which is a satellite offering and a full sort of set top box recording capability, all the way through to over the top offerings as well where we have the number one sporting apps in the country which you get incorporated into your mobile plans as well. And so we're offering media across both mobile and across both and fixed. And the interesting thing for us is that we know there's no doubt that media is a very important part of telecommunications offerings to customers. The interesting thing about our strategy is that we effectively have exclusive access as the telco reseller to all of the IP based content of Foxtel which is the largest - by a very, very significant margin – the largest owner of content in the country and we have exclusive access to that and that's a very, very good partnership. So we own 35 percent of that business. We haven't as much had to go out and buy direct rights. We do own the mobile digital rights on the football and the NRL, but our options, we have more options. So for example Foxtel has just bought all of the rights of the cricket for the next five years which is a big sport in Australia. We will get exclusive access to that for our customers again as a telco reseller. So that puts us in a very, very strong position from a media perspective. So we've got the Australian soccer, we've got the Australian football, we've got the rugby, we’ve got Formula 1, we’ve got cricket, we've got right the way across the range so I think a media offering is by far and above any other competitor in the market.

[Eric Pan] Switching topics 5G probably going to be the most talked about topic at this conference just like last year. It seems like the first wave of the rollout that's to come early next year is really more probably going to be about getting that marketing edge. Besides being able to offer more data inclusions, are there other potential new revenue streams or products they can offer that can drive consumer ARPU?

[Andrew Penn] Well I think in the long term, I mean, what we saw clearly with 4G is there's a proportion of the population that are early adopters of new technology and they will absolutely and definitely want to move to 5G, and move to 5G early. I think as you mentioned a lot of the activity at the moment is more I would call in the technology innovation space, trials, and a bit of marketing. Not just from the telcos by the way but from the equipment manufacturers as well. So the people who you know, the Ericsson's and the Nokia's and the Huawei's of the world are obviously all significantly competing to be the leaders in this sort of technology. There's obviously use cases for fixed wireless offload is a use case, the Internet of Things obviously is a longer term use case and just basically the other piece is the economics of the capacity and speed improvement through 5G just means that the capex cost per gig of data transmission will come down if this technology step, which is critically important from a capex point of view if demand for data is increasing.

[Eric Pan] And in terms of just the capex that could be involved with the 5G rollout. You know you announced over the past couple of years in late 2016 that you will be investing in the additional billion dollars a year over 17, 18 and 19 into investing into the network, into the company. Can you just talk a little bit about where some of that strategic investment is going into it and how far along you're tracking?

[Andrew Penn] Sure. So we're about halfway into that overall investment and the weight of the investment to date has been on the network side. We have a parallel program which is really on the IT side and digitising the business and I'll come to that in a second. But on the network we have for example, we've launched two IoT platforms. Probably the largest in the world with narrowband and cat M1 IoT platforms out there. We've increased capacity speed and resilience in the mobile network. We've extended out mobile network reach by probably more than another 100,000 square kilometres where we have the greatest coverage in the country. We've increased the capacity. We’ve completely upgraded the core optical transmission backbone networks that gives us about five times the capacity that we previously had and and importantly we've also rolled out what we call the next gen OSS which goes to the point I was making earlier about technology which is effectively our own digitised OSS where we are increasingly having to rely on machine learning and data analytics and software engineering to actually run the network, to make sure that the networks self-correcting, self-healing, self-correcting. And we've rolled out that whole platform as well and that's also given us the ability to manage our customer experience and have a much closer contact with more customer experiences all the way down to individual handsets and individual modems in the home as an example.

And so that's been critical on the network side and all really aimed at providing the backbone and the support as we move to 5G.

Then on the digitisation side the program in the early stages has been really sort of aimed at some quick wins in really improving customer experience, customer service, and also supporting our productivity program. But also behind the scenes we have also been building a completely new technology stack for both our enterprise customers, and that's actually now live and in the market, and also for our mass market consumer, mass market customers, so consumer small medium business, and that will be live in the market in the second half of the calendar year. And those two are really important platforms for us to continue to develop our product suite with the customers, and in Enterprise for example we recently launched something called Telstra Programmable Network which gives enterprise customers the ability to dynamically manage their network requirements digitally themselves so which is a pretty cool capability.

[Eric Pan] I just want to open the floor up for questions if anybody has any questions just raise your hand, a microphone will come to you.

[Question] Hi thank you for taking my question. I'm just wondering in terms of the data usage or overage charges, can you help us to dimension just how meaningful that is as a percentage of ARPU and to what extent if we go to full unlimited can that fall out from your earnings stream?

[Andrew Penn] Yeah look we haven't disclosed the exact numbers but it's material enough to obviously impact ARPUs to the extent that I've talked about this morning. In terms of what's the potential for that to, I guess be exacerbated by unlimited, if you look at the US, I think in two years they've moved to about 30 to 40 percent if you look at someone like a Verizon, as I understand there about 30 to 40 percent into the base is moved to unlimited and I think ultimately how that plays out in Australia is a function of how pricing plays out and that's a competitive dynamic but we have priced our unlimited plan is clearly more expensive than our ordinary data plans. And so therefore you know the actual data allowances in many of the mobile plans in Australia today are very generous and so it's, you know, it's not really necessarily in the interest of every customer to pay the extra to move to unlimited and so I think the rate of that sort of switch will be a function of how that pricing dynamic plays out into the market and at the moment, I don't have a forecast on it because I can't forecast it, but it is interesting to look at the US where as I say it's taken a couple of years and it's at about 30 to 40 per cent through the base of the big players.

[Eric Pan] Going back to the capital spending. Over the years 17, 18, 19 you talked about a capital intensity at 18 percent..

[Andrew Penn] Yes

[Eric Pan] ..of service revenue and then falling back to 14 percent thereafter. Now does, how much of the 5G capex is included in those figures. Is it just for non-standalone radio rollouts or will when the time comes when you do have to do standalone radio rollouts can we expect the capex to be higher?

[Andrew Penn] Well as I say, we aim to have a long term capex to sales ratio of 14 percent. There's no doubt, you know, obviously there's times it's higher than that and times it's lower than that. I think on 5G it really depends on how the use cases play out so the more demand there is for small cell densification that typically will drive a higher capex demand than just for sort of conventional bonding with 4G so but at this stage we are not planning to increase our capex at this stage we're planning to accommodate 5G within our 14 percent capex to sales ratio and importantly a lot of the foundation investments that I mentioned it's not just you you're obviously got to with 5G it's obviously about building new capacity and new equipment in the RAN, in the radio access network, but you've also got to build the capacity at the backhaul and in the core to support that extra volume and that's part of what we've already been doing in terms of the investments we've already talked about.

[Eric Pan] Got it. You also have a current cost out target of $1.5 billion by fiscal 22. Now that amounts to roughly 10 percent of your total opex or 15 percent when you're excluding COGS. Is there room to do more or faster and how are you tracking versus your target?

[Andrew Penn] Yes so in terms of the last part of the question first. How we're tracking is we are about $500 million into the $1.5 billion. We haven't formally increased that target but I have said on the record that I do believe that we need to do more. As you say that's about 15 percent of our core non-DVCs. We are doing work on our DVCs as well but I mean obviously they're driven by a different sort of dynamics whether they're commissions, and we've brought down commissions fairly substantially, or handsets and other types of COGS. But to your point it is about 1.5 billion out of about 7 billion in terms of and that's in nominal terms by the way so that's obviously after taking into account any volume increases or inflationary increases. So in that sense it's more than 1.5 billion. But I do think we need to do more than that but we haven't formally announced what that looks like yet.

[Eric Pan] Got it. Now in terms of the, you know, the capital returned your current dividend policies pay out 70 to 90 percent of underlying earnings. Now by our estimates your underlying earnings could dip well below 22 cents which is your current dividend by fiscal 21. But your payout ratio, which is a percentage of free cash flow, would still be less than 80 percent. If such a scenario actually comes to fruition can we expect another dividend cut or are you ok with paying more than 100 percent of earnings for a short period of time as long as your free cash flow can support it?

[Andrew Penn] Look I think ultimately the dividend is going to be a matter for the Board. You know clearly we have confirmed our guidance for dividend this year at 22 cents and ultimately our ability to pay dividend obviously will be a function of the performance of the business and that's going to be impacted by obviously the market dynamics. So I can't comment any further on the dividend at this point, other than to say that I know it's extremely important to shareholders and investors and you know something we're focused on and we're focused on ultimately implementing the right business strategies to ensure that we perform to the best of our ability in the context of the market we are in.

[Eric Pan] Right. And is your target leverage still 1.3 to 1.8 turns and can we expect additional capital returns when you go below that range?

[Andrew Penn] Yes, so our target ratio is that. We target to basically be - well actually that the target is more to do with the credit rating metrics that we feel we need to be roughly within a band, so it's the A band that's sort of slightly more significant than the 1.3 to 1.8. Well that's what we estimate that needs to be and part of the reason for that is that we've always maintained the position of having a relatively strong balance sheet I think particularly through a period of significant competition that's important as well and of course as a large borrower in Australia the debt markets in Australia are not quite as deep as they are for big, big borrower like us and so we do source a lot of debt internationally and we find a stronger balance sheet helps us in that as well. As regards capital management initiatives again I couldn't comment sort of or provide any forward sort of projections in relation to that. I note we have over the last couple of years returned significant amount by virtue, by way of dividends as well as on market and off market buybacks so we have a history of doing capital management initiatives to make sure that we manage the balance sheet as effectively as possible. The other thing that we are always very cognisant of is to return franking credits which possibly are less well known here in the U.S. but are very important in Australia and we do our best to make sure we return franking credits which are valuable to shareholders as quickly as we possibly can.

[Eric Pan] Right, any other questions from the floor?

[Question] Do you see increased ARPU from 5G?

[Andrew Penn] The question was, I'll repeat the question because we're webcast, but the question was do I see increased ARPU from 5G. And I think yeah as I said over the longer term yes I do. Definitely I think you know as we have seen with previous technology evolutions we have seen early adopters of that technology that want to get access to the new technology and are willing to pay more. We saw that with 3G we saw that with 4G and I think we will see that with 5G as well. So I think it'll increase ARPU from that perspective. There has been a pattern of course though of that then getting competed over time. But I think in the end of the first couple of years that's absolutely an opportunity. And it really goes to the heart of my point earlier is that can the telcos take or put themselves in a position to create more valuable or take more of the value that is created. And I think that's where investing in the capability to build services and applications which leverage the network not just the underlying network itself are going to be important. And we've done a pretty good job on that in the enterprise sector. And our challenge will be how do we now drive that down into the mid-market business sector and small medium businesses as well.

[Eric Pan] Switching gears onto the fixed segment, you know the nbn and the National Broadband Network. In the past you've said that you don't really make any money under the current wholesale pricing structure. Where does pricing need to go before it starts making economic sense for yourself or any of the RSPs?

[Andrew Penn] Well look I mean it's unfortunate but I mean the bottom line is is that wholesale prices have more than doubled under the National Broadband Network and they're set to increase even further and I've been quite clear that, I understand the drivers for that, but in the end I think the problem is that that will ultimately make fixed broadband unaffordable for consumers in Australia and that's a bad thing. And I do know that nbn has been deploying a number of initiatives to try and, if you like, improve the wholesale pricing but you know it needs to come down like $20 not $2. I mean it's orders of magnitude. There needs to be a big shift in the wholesale pricing because I think otherwise in the long term both the nbn model will be unsustainable as well as frankly fixed broadband for consumers in Australia will be unaffordable. And with alternative technologies, you know, coming such as 5G you'll see potentially more customers choosing to go to Mobile only than to a fixed service.

[Eric Pan] Right. And there's a lot of talk from both your competitors and within the industry about the potential for fixed Wireless Broadband. You know, in the States you have AT&T and Verizon actually implementing and rolling it out. Is there any reason why we wouldn't see significant uptake of fixed Wireless Broadband in an urban and suburban areas in Australia if the alternative for the consumer is fibre-to-the-node?

[Andrew Penn] No no, there isn't any reason why you would not see it. You know again, I've been on the record as saying that the one point that I've made is that 5G is not going to completely replace the nbn. But to your point there's no doubt that more customers will choose to go to mobile only and 5G is going to provide them with a technology that's going to make that increasingly feasible. Now I think we saw some estimates that up to 15 percent of homes in Australia in addition to those that already are mobile only could move. That's about a million homes.

Whether it's 15 percent, whether is 20 percent, I don't know. We will see obviously. And still the 5G technology itself, particularly in the fixed wireless space has still got a way to go from an innovation point of view and the millimetre band wave spectrum in Australia will not be available until sometime into probably the second half of 2019. So that's still ahead of us, but there's no doubt absolutely more customers will go to a wireless solution against fixed. Which is why, as I go back to my point earlier on the wholesale pricing on fixed, it’s why it's important on that issue is tackled so that we have equilibrium in the market between fixed and mobile and customers can pick the best solution for them based on the technology that's available.

[Eric Pan] Right. We have time for one or two questions from the floor if anybody has any? Okay so continue on that discussion, do you believe that ultimately mobile and fixed connectivity will converge in the future or people will have just one bill for their mobile needs?

[Andrew Penn] Look, I think that from a customer's perspective, customers shouldn't really ultimately have to worry about how they are connected, they just want to be connected. So whether it's through mobile, or whether it's through fixed, whether it's a Wi-Fi configuration, and in fact whatever the underlying technology is, whether its cable, fibre, satellite, 5G, 4G. I mean in the end what customers want is they want a great network experience at an affordable price and no surprises. And so I do think that, you know, the industry has to move to that place.

And obviously, the underlying economics and the technologies are very different. But that's a problem for the industry to solve, not to be foist onto the consumer and the customer. But if we got back to that previous point that we discussed, the reason I said that 5G will not replace the nbn 100 percent, is because currently today in Australia the average customer uses about a 150 gigabytes of data per month on their fixed broadband service, ie. their fixed broadband service at home which is what's migrating to the nbn. And the average mobile customer uses five, so that's a 50 times difference in capacity. So if you were to try and build the capacity on a mobile network to fully shift all of that fixed volume of data off a fixed onto mobile, that would be a multi billions of dollars of investment and at a point, at an inflexion point, that's not viable. But certainly at the 10-20 percent level, yeah absolutely, customers could shift.

[Eric Pan] Right. I have one last question for you. Now, so, with the nbn migration you're decommissioning some of your exchanges and I believe you're looking to sell about the half of the 5300 exchanges you currently have, together with the land under them. With the real estate prices in Australia at historic highs, and most of your exchange sites in prime areas, do you have an estimate of how much that's worth?

[Andrew Penn] We haven't provided a valuation expectation. I think we have provided the book value, which is about a billion dollars, of the assets. And essentially for the audience, we currently have about five and a half thousand exchanges. About half of those exchanges are required by the nbn for their servers, but the other half will become available in the roll out, and it's our intention to effectively liquidate those once we can decommission them, and that does offer some potential value upside.

[Eric Pan] Great. Well I want to thank you Andy for joining us and have a safe trip home.

[Andrew Penn] Well thanks very much Eric. Thanks for the opportunity to speak. We're excited to be here. As I said, I am very confident and optimistic about the long term for the industry, but there's no doubt that there are some very immediate and short term competitive challenges. We are responding to those and we do have a further market briefing where we have some very exciting initiatives which are building off the strategic investments that we've made to date, that we will be announcing later in June as well. So thank you.
[Eric Pan] Thank you.