
Patience virtue in wait for T3 to deliver

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INVESTMENT NEWS

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The new Telstra tranche may be best for self-managed super funds or geared investors, **James Dunn** reports

THE nuts and bolts of the Telstra 3 offer are simple. Retail investors pay $2 for an instalment receipt (IR), which gives them full entitlement to Telstra dividends. The $2 for each IR is due on November 24. Existing Telstra shareholders (those on the Telstra share register before October 14) are entitled to a minimum 3000 shares.

In May 2008 a second payment is required to convert the IRs to Telstra shares: this final instalment amount will be announced by November 20. If you hold your IRs until the second instalment and pay this on time, you get one bonus Telstra share for every 25 shares bought.

The Telstra board has declared that it intends to pay a fully franked dividend of 28c a share for the year to June 30, 2007. Effectively, this gives the IR holder a 14 per cent yield, which grosses up to 20 per cent due to the franking. This is equivalent to an after-tax yield of 10.7 per cent for a 46.5 per cent taxpayer.

The franking credits are even more attractive to a self-managed super fund (SMSF) on a tax rate of 15 per cent, which gets a tax refund of $215 for every $1000 of dividends it receives.

Due to the high yield and full-franking credits, many investors, and particularly SMSFs, will pile in as a yield play, certainly in the first year. But Telstra has not guaranteed a 28c dividend in 2007-08 and analysts can't agree on whether it will happen.

At 28c, Telstra's dividend costs it about $3.5 billion a year to fund. In recent years, it has funded this by borrowing $1.5 billion. While not accepted practice, it can afford it. Telstra's earnings before interest, tax, depreciation and amortisation (EBITDA) cover its net interest bill by more than 10 times.

The dilemma for investors looking at Telstra as a long-term investment is whether the dividend is sustainable. What are its earnings prospects? Telstra has large regulatory issues — for example, its scraps with the Australian Competition and Consumer Commission over what it charges for access to its networks. It also operates in an intensely competitive market.

Countering that, it has scale that most of its global peers would kill for: virtually none of Telstra's global peers has the scale in fixed-line, mobile, broadband internet, pay-TV and directories that it has. One big question remains: can it reduce its costs to leverage this scale?

For these reasons, T3 — and the stock itself — is rarely spoken of as a capital growth prospect. The pain of the thumping 51 per cent capital loss on the T2 shares is still too fresh in investors' minds.

"Telstra is growing in value, but very slowly," says Clime Asset Management managing director Roger Montgomery. "Most retail investors think in terms of price, but that's irrelevant. The value of the business has been rising steadily since it first listed in 1997.

"In T1 the shares were offered to retail investors for $3.30, when on our calculation the business was worth $2.56. In T2, the shares were offered to retail investors at $7.40, when the business was worth $2.69. Now in T3, we reckon the value of the business has risen to between $2.80 and $3." But that value is less than T3 participants will pay for, so they do not think it is worth getting involved in.

Charlie Aitken, director and head of institutional dealing at broking firm Southern Cross Equities, has a very different view. He says the pessimism of analysts means T3 is "the best large-scale, large-cap contrarian investing opportunity that will present itself in Australia this decade".

"The Government has priced T3 almost as a junk bond. It is offering interest-free vendor finance to investors, giving buyers a full dividend stream for 18 months and jacking up the yield to 14 per cent fully franked."

Investors looking for yield, he says, will buy the IRs. "Even at $2.40, they still will yield 11.6 per cent fully franked. When you add on the second tranche of, say, $1.60, you can see secondary market retail demand for IRs driving the Telstra head share price above $4 in the next year."

This could only be the start, he says. "If you assume Telstra's 28c dividend is sustainable, as I do, and if the market started believing it, too, there's no reason why Telstra shares would not be driven, in time, to a dividend yield similar to the banks. Telstra paying a sustainable 28c dividend and trading on a yield of 5 per cent would see the share price at $5.50," he says.

Aitken therefore believes that gearing into IRs via instalment warrants will be rewarded.

On that front, Pia Cooke, senior manager for equity markets at Macquarie Bank, says an "absolute plethora" of T3 instalment warrant products is set to hit the market soon.

"These will range from short-dated trading instalment warrants and long-dated investment warrants over T3, to self-funding instalment warrants, where you reinvest dividends to repay your loan, and high-yield instruments that offer you a much greater dividend than T3 receipts."

But you must take into account the funding cost. That is, for a 28 per cent yield, you would pay interest of 7.95 per cent on Macquarie's product.


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