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**TELSTRA
STOP REMINISCING.**

“...You are neither right nor wrong because the crowd (agrees or) disagrees with you. You are right because your data and reasoning are right.”

Benjamin Graham,

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Occasional outbreaks of those two super-contagious diseases, fear and greed, will forever occur in the investment community. The timing of these epidemics is equally unpredictable, both as to duration and degree. Therefore we never try to anticipate the arrival or departure of either. We simply attempt to be fearful when others are greedy and to be greedy only when others are fearful. **Warren Buffett**

"At some point in the growth of a boom, all aspects of property ownership become irrelevant except the prospect for an early rise in price. Income from the property, or enjoyment of its use, or even its long-run worth are now academic...What is important is that tomorrow or next week market values will rise—as they did yesterday or last week—and a profit can be realized." **John Kenneth Galbraith**

The Government has just announced the sale of its remaining 51% stake in Telstra, via a public offer and placement of shares (approximately 30%) into the Future Fund.

Most of the press in the days following the announcement on August 25 is predictable. There are the reactions from the company, investment professionals and even the general public! Yep, a Vox Pop on the merits of investing in Telstra – I thought ASIC required you to have a licence before giving advice. There is the analysis about the company's prospects, its positives and negatives. There is the analysis about whether investors should line up and then there are the discussion pieces covering what the terms of the offer might be. All that press and the terms of the offer aren't yet known.

For the record, we make the following prediction and observation; the installment receipt structure puts Telstra in play for a corporate raider. As Alan Kohler suggested in the Sydney Morning Herald on August 30, a wholly debt-funded purchase of 5% of the company would be more than fully funded by the 28 cent fully franked dividends flowing out of the company and the interest would be tax deductible (and the Capital Gains may end up being tax-free for an overseas suitor). After buying 5%, an EGM could be called with a proposal to split the company, putting the network assets into what could potentially be a very popular infrastructure fund. Indeed offering everyone an entitlement to it, could generate the necessary votes. And the coat-tail riders could very quickly add impetus to a share price rising simply because many institutions are underweight or even short the stock

Back to reality and those articles again. Virtually all contained some reference to the much higher prices the shares once traded. "Investors are angry over the heavy losses incurred on T2 shares"¹ We'll put aside the argument that it was the upbeat press and 'analysis' during the T2 raising that resulted in the high subscription rate by less

¹ Telstra: it's a whole new call game *Australian Financial Review* Pg 44, Sep 2-3, 2006

sophisticated investors. By drawing the reader's attention to the declining path of the share price, the authors imply the company is a shadow of its former greatness. If true, it must follow that the \$9.00 prices of the year 2000 accurately reflected the former "greatness" of the company. It is this point that is, as Charlie Munger would say, twaddle.

I do not plan on making any firm recommendation here about the future of the business – which has its fair share of problems, its prospects or its management. Nor will I speculate about the terms of the proposed sale. What I will do however, is make the assumption that the total sale price will be close to the current market price and then point out something that all of the articles discussing the planned sale have failed to – that an offer of shares at or below the current price would be infinitely more attractive than each of T1 and T2 simply because the market price is closer to the actual intrinsic value.

And this has nothing to do with the possible dividend yield that, while attractive, is merely a function of the likely installment structure of the offer.

When the company was first listed, through the sale of one third of the government's stake in November of 1997, retail investors paid an initial installment of \$1.95 per share followed by another \$1.35 in November of 1998. Institutional investors were required to pay 5 cents more at each installment. The Government's objective for the sale was to achieve an "optimum financial return from the sale"². And don't ever forget that. Vendors time their sales to get the maximum price for themselves not to offer the best value for buyers in a float.

Prospectus pre-registration invitations were sent to 8.7 million Telstra customers, Telstra bond holders, CBA shareholders and broker clients. Over 1.3 million people contacted the share information call centre, 26,000 registered on the internet and roughly 500,000 obtained a prospectus through their broker or a CBA branch.

At its conclusion, 1.8 million retail investors applied for 3 billion shares and 2.6 billion were allocated.

Gross proceeds from the sale to the Commonwealth were estimated to be \$14.24 billion with \$5.85 billion received in the second installment.

And, several items in the Audit Report into the sale and published by the Australian National Audit Office, suggested that the government could have achieved a higher sale price (and probably paid a little too much on the fees to get the job done).

In 1996-97 the company had the following financial performance profile:

² *Sale of One-third of Telstra*, Audit Report, Australian National Audit Office ISBN 0 644 39025 5

Telstra's financial performance: 1992-93 to 1996-97

	1992-93 \$bn	1993-94 \$bn	1994-95 \$bn	1995-96 \$bn	1996-97 \$bn
Operating Revenue	12.7	13.4	14.1	15.2	16.0 ^a
EBDIT ^b	5.3	5.7	5.6	6	6.6
Operating Profit	2	2.5	2.4	3.4	2.1
Income Tax	1.1	0.8	0.6	1.1	0.5
Operating Profit	0.9	1.7	1.8	2.3	1.6
Shareholders Funds	10.9	10.8	11.7	12.7	9.9 ^c
Total Assets	23.2	21.1	24.1	24.4	25.9
Dividends	0.7	0.7	0.9	1.4	4.1 ^c
Earnings Per Share (cents)	8.2	13.7	13.6	17.9	12.6

(a) Telstra yearly results were announced on 26 August 1998 with revenues growing by 8.3 per cent to \$17.3 billion compared to the prospectus forecast of growth of 4.7 per cent.

(b) Earnings Before Depreciation, Interest and Tax (before abnormals).

(c) Includes a \$3.0 billion special dividend paid to the Commonwealth on 30 June 1997 as part of a recapitalisation of the company.

(d) Source: ANAO analysis based on information from the 1997 Australian Public Offer Document.

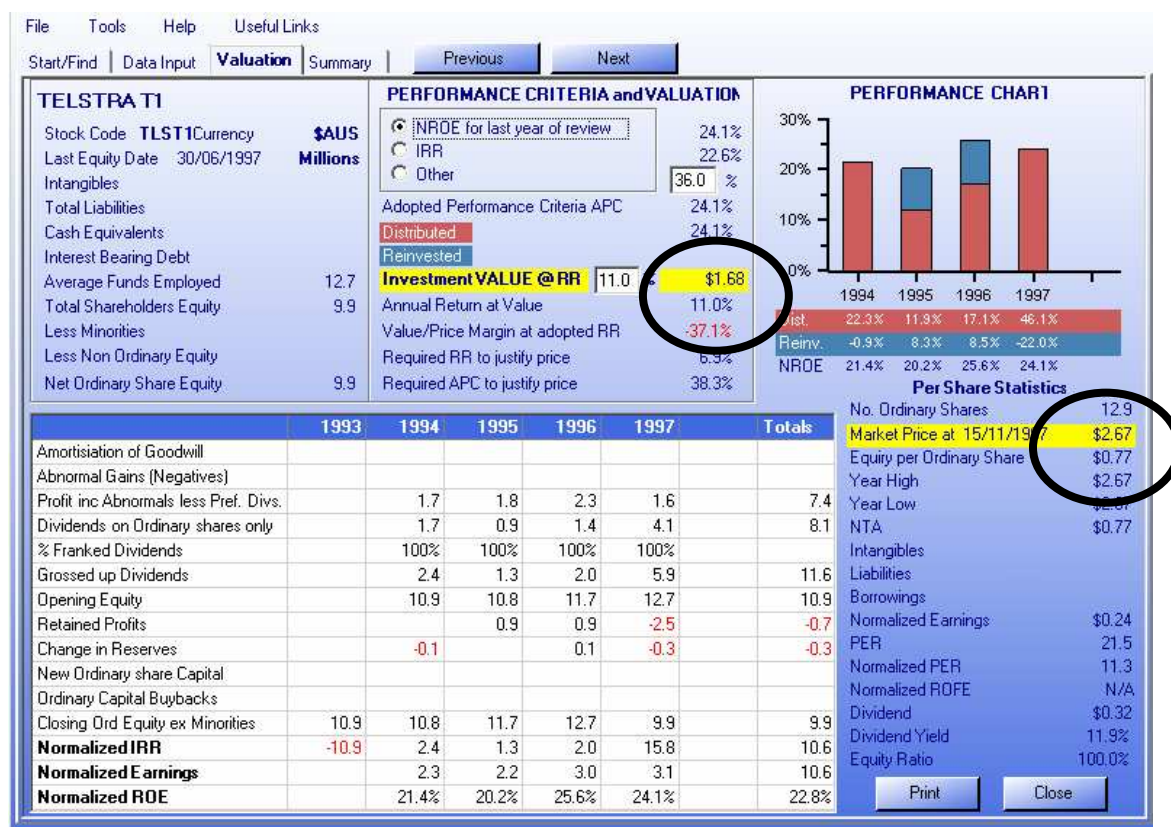
What was the business worth to a rational investor when it listed?

To estimate this, we need the above data, the total number of shares on issue, an estimate for future return on equity and an assumed required return.

Assuming that the 24.1% rate of return on equity achieved in 1997 would continue and adopting a required return of 11% results in a valuation of \$1.68.

As shocking as the result is, it is the result of a rational approach to valuation. If a business has 77 cents of equity per share, generating a sustainable return of 24% and virtually all of those earnings are paid out as [fully franked] dividends (which was the case over the preceding 4 years), then an investor demanding a return of just 11% would be willing to pay a little more than twice the equity per share to ensure his return was achieved. See Table 1.

Table 1. T1 Stockval Valuation. www.stockval.com.au



A more generous analyst might have arrived at an estimate for future return on equity of, say, 35% (rather than the 24% adopted above) and having done so, produced a valuation of \$2.51. Indeed, several analysts were implying a return on equity of around 35% at the time. At the close of the first day's trading however, Telstra's installment receipts were \$2.67, a 'healthy' premium to the initial \$1.95 paid by share investors and a 'steep' premium to the businesses value on a per share basis, remembering retail investors (here we use the noun, *investor*, loosely) still had to pay another \$1.35 a year later!

At the close of the first day of trading the shares were trading at a fully-paid-equivalent price of \$4.02, a 60% premium to the estimated value of the business of \$2.51.

But of course, as history now records, the premium expanded even further as the share price continued to 'strengthen', profits improved and the internet bubble lay just around the corner.

By 1999 the market was enamoured, enraptured and besotted with Telstra.

On the weekend of June 26, 1999 *The Australian* Quoted an analyst;

“the growth premium you are being asked to pay for Telstra now does not take into account any of the goodies in the pipeline that are likely to start appearing over the next couple of years. We have a target price of \$20 on the stock by 2003, but all that assumes is above average earnings growth and continual expansion in the ... price-earnings ratio the market is prepared to pay ... The risk/reward profile is better than you will get anywhere else ... and the likelihood of Telstra outperforming the market over a longer period is very, very good.”³

On the same weekend *The Australian Financial Review*, in an article entitled “**Why Telstra II Is Worth Buying**” provided the following information:

“for those investors considering buying shares in the Government’s second sale of Telstra Corp. - the largest public offering in Australian history - the message from the experts is ‘go for it.’ Telstra is worth buying, they say, because the company has a strong financial base, great growth prospects and an experienced management team.”

Perhaps referring to just this coincidence of ‘buy’ recommendations by analysts and advisers, Warren Buffett noted;

"A pack of lemmings looks like a group of rugged individualists compared with Wall Street when it gets a concept in its teeth."

Warren Buffett

This was a good time for the government to take advantage of ‘irrational exuberance’, which is precisely what it did, perhaps with alacrity.

On the 22nd of September 1999, Telstra, with its shares trading around \$7.94, issued a second prospectus for the sale of 2.1 billion of the Government’s shares. The final price for institutional investors was \$7.80 and for retail investors, \$7.40.

Once again the float, from the perspective of the vendor, was a stunning success. The government in its announcement following the closure of the offer proudly declared: “The Commonwealth is delighted with the excellent response from both retail and institutional investors to the Telstra 2 Share Offer, the largest in Australia’s history and the largest in the world so far this year.”

Thanks in no small part to the price the shares were being offered at, T2 was indeed the largest offer in Australia’s history, but between T1 and T2, had the valuation of Telstra

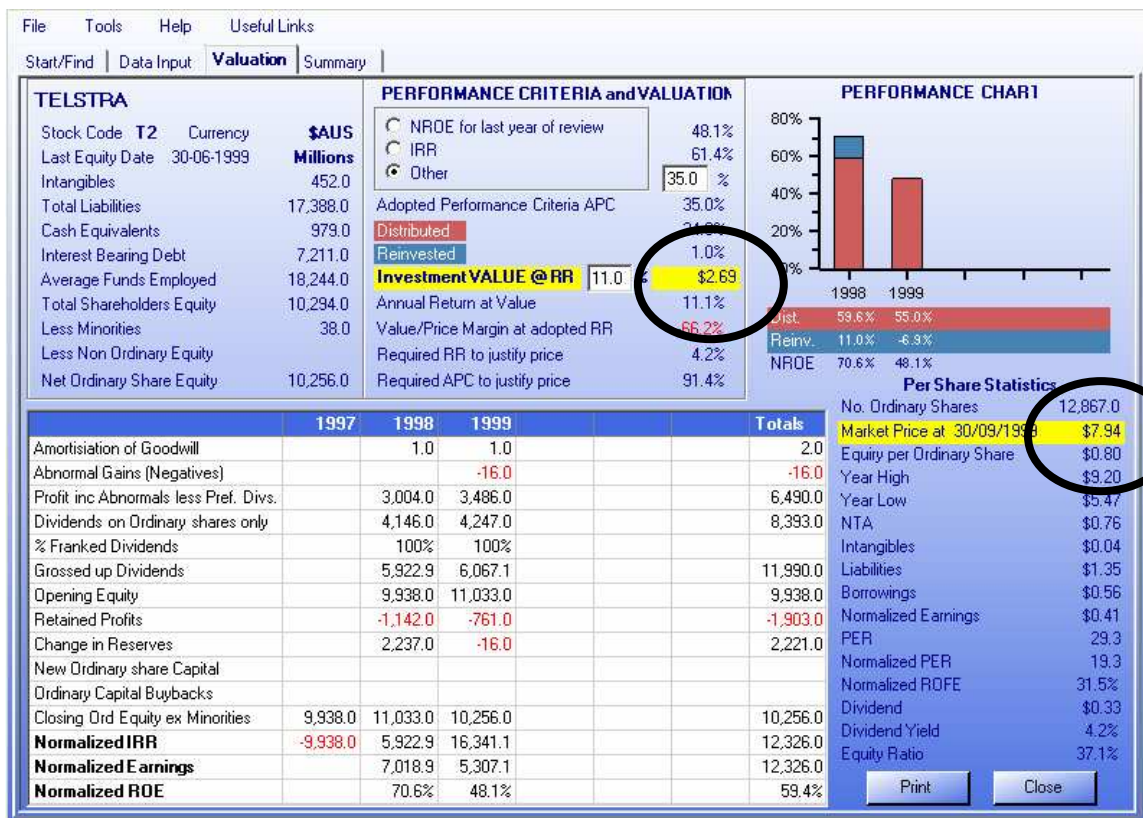
³ The Weekend Australian 26-27 June 1999.

changed as dramatically as the price?

Table 2 uses our valuation model again to estimate the value of Telstra's shares following the release of the 1999 profits. Telstra generated a return of 48% to its owners on 80 cents of equity and continued to pay the bulk of its earnings out to shareholders in the form of dividends. Assuming *this* rate of return were to continue and adopting a required return of 11% (probably not high enough) for a sharemarket investor, a reasonable price to pay would be almost 5 times equity or \$3.81. If however a more sustainable return on equity were adopted, say, 35%, the valuation drops to \$2.69.

Between 1997 and 1999, the value of Telstra had risen (maintaining ROE and RR assumptions) from \$2.51 to \$2.69. The price vendors asked investors to pay also rose, but substantially more than the increase in value and so, investors in T2, once again missed out on any margin of safety. Instead they paid almost three times the value of the business at the time.

Table 2. T2 Stockval Valuation. www.stockval.com.au



How can the 'market' be so stunningly wrong? Because it is not comprised of sophisticated investors who know how to value a business. The market is instead, as Ben Graham described it in his Mr Market allegory. It is great at getting things right in the long term, but terrible at getting things right in the short-term because it has

“incurable emotional problems”, suffering from extreme bouts of optimism, pessimism and temporary insanity.

He counselled in the 1940’s;

“you must heed one warning or everything will turn into pumpkins and mice: Mr. Market is there to serve you, not to guide you. It is his pocketbook, not his wisdom, that you will find useful. If he shows up some day in a particularly foolish mood, you are free to either ignore him or to take advantage of him, but it will be disastrous if you fall under his influence. “

But in 1999, few investors nor their supposedly more sophisticated advisers were willing to listen. Having missed out on T1, they weren’t going to let T2 get away. They ignored the very obvious fact, shares in Telstra, were already trading and that in order to make similar gains as the T1 participants had, the market capitalisation of the entire company (the price or market value of the entire business) would have to rise another 132%. All of the shares, not just the T2 shares they had purchased would have to rise to more than \$18.00 each.

The enthusiasm on the part of retail investors for T2 shares, in the face of their lack of enthusiasm for the existing T1 shares already trading on the market, reflected a complete and absolute lack of understanding of the mechanics of the share market and the process associated with a vendor selling down a few more shares. This is another example of Australian investor’s lack of sophistication.⁴

"Success in investing doesn't correlate with I.Q. once you're above the level of 25. Once you have ordinary intelligence, what you need is the temperament to control the urges that get other people into trouble in investing."

Warren Buffett

It was simply the fear of missing out that made T2 so popular, but what the wise man does in the beginning, fools do in the end.

With the asking price for T2, \$7.80 and the valuation at \$2.69, the differential between *Price* and *Value* was so great that a clear and rational response to the hype would have been to ignore the offer completely.

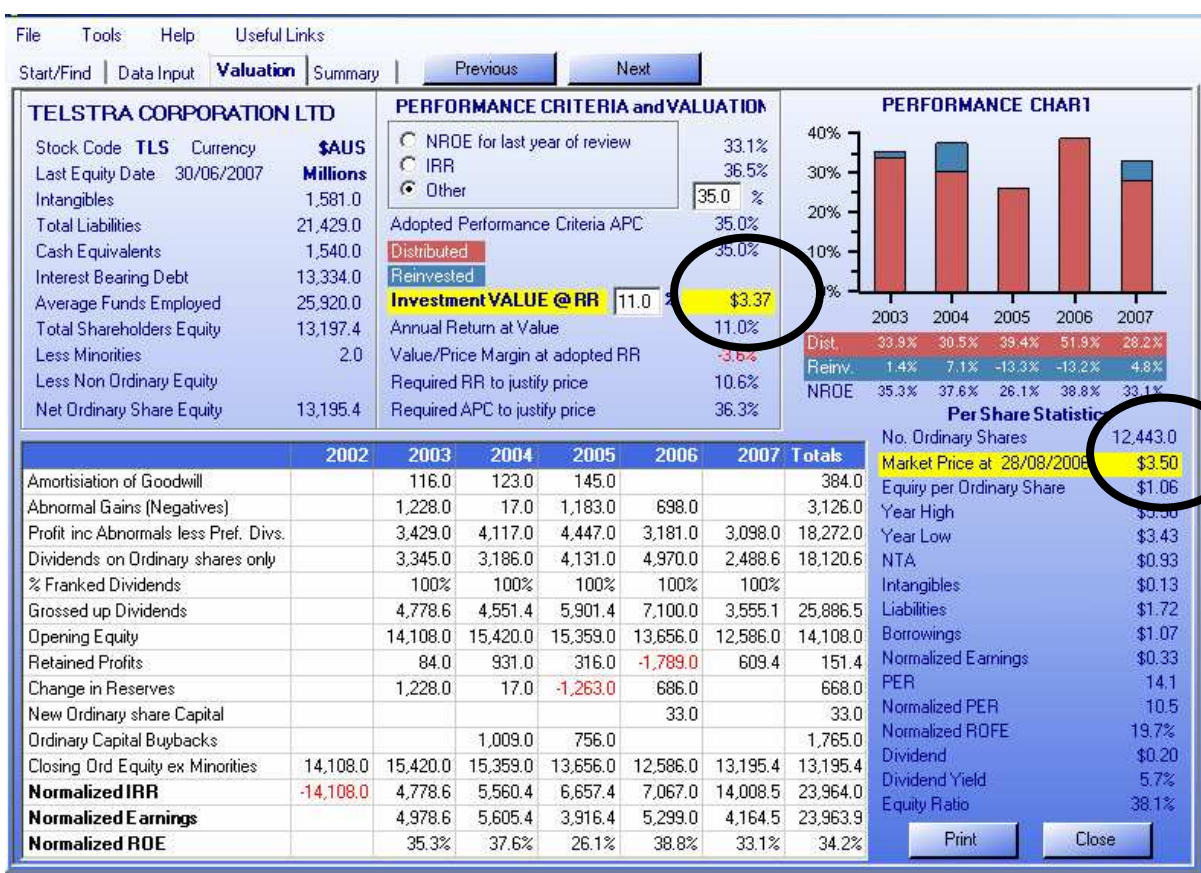
⁴ “Australian traders and investors are more sophisticated today than ever before” Deutsche Bank Press Release SYDNEY 5 NOVEMBER 2003 *Deutsche Bank makes a splash with new Warrant Alternative Vehicles (WAVEs™)*

Few did, and millions of shareholders are currently still wondering what to do.

With the government's announcement of the sale of the final tranche and a placement of the remaining shares into the Future Fund, under a two-year escrow arrangement, many experts, advisers and investors will be wondering whether they are throwing good money after bad by investing in T3 or whether this will be an opportunity to recoup some of the T2 losses.

Using our valuation model, once more in Table 3 and adopting our 11% required return and a forecast 35% future return on equity, we find that each share, represented by \$1.06 of equity, is worth \$3.37.

Table 3. T3 Stockval Valuation. www.stockval.com.au



The rise in the value of the business since 1997 is purely a function of the estimate that a 35% return on equity can be maintained on gradually increasing equity. This assumption may or may not be a realistic but the best investors are those that estimate return on equity most accurately or conservatively.

We would guess that return on equity will be lower over the next few years and if the dividend falls, the franked component of return on equity that is paid as a dividend will be lower. The retained component will be employed at around 24%, which means the actual valuation is closer to \$2.80. And lower (\$2.60) if we adopt a more appropriate discount rate. The purpose of the exercise in this note, however, is to demonstrate the fact that the prices the Government has previously asked its constituents to fork out, bears little resemblance to the valuation on a constant assumption basis. Only now are value and price approaching a meaningful relationship.

The following Table summarises the differential between value and price at each stage of the government's sell down of Telstra.

Table 4.

The Government's Selling Telstra Again!

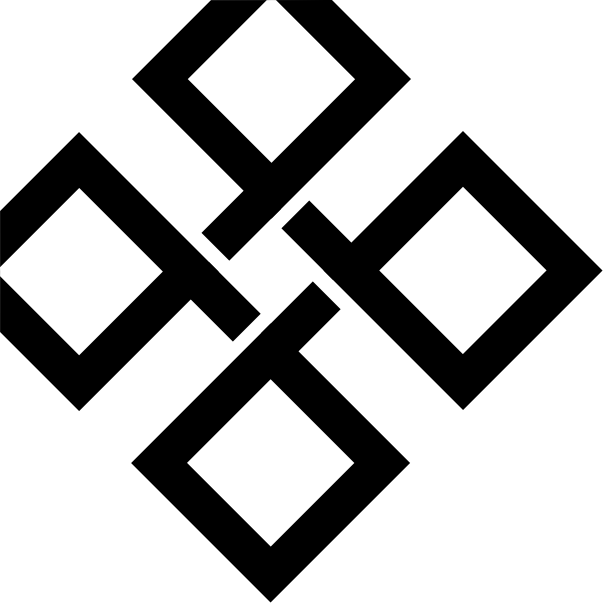
	T1(1997)	T2(1999)	T3(2006)
Vendors Price	\$3.30	\$7.40	???
Clime Valuation	\$2.51	\$2.69	\$3.37
Equity Per Share	\$0.77	\$0.80	\$1.06
Fcast Return on Equity	35%	35%	35%
Discount Rate	11%	11%	11%

The slowly but steadily increasing valuation (assuming the investor is satisfied that a 35% return on equity is sustainable, the company's prospects are bright, management is competent and will always act for the benefit of shareholders and that an 11% required return is sufficient) is in stark contrast to the much less stable share price over the same period of time which rose from \$4.05 in 1997, to over \$9.00 in 2000 and back down to \$3.50 in 2006.

Benjamin Graham observed that in the short run the market is a voting machine - a popularity contest, if you will - but in the long run it is a weighing machine. In the long run the market price tends to follow and eventually reflect the value of the company. So the current price is perhaps, only now, properly reflecting the value of the company - it has certainly had enough time to get it right. As a result - assuming the value of the company continues to rise - this *third* sell-down of Telstra may be the *first* time that the government offers its constituents a real investment opportunity - an asset at a discount to what it may be worth.

Clime Capital Limited
August 2006

Cont/d -



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