Telstra Corporation's AUD 1 Billion Off-Market Buyback
Superannuation Funds in Pension Mode and Individuals on Nil Tax Rate Are the Big Winners

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Executive Summary

In mid-August, Telstra Corporation reported a solid fiscal 2014 result, with underlying net profit after tax, or NPAT, of AUD 4 billion, and a final, fully franked dividend of AUD 0.15 per share, in line with our forecasts. Nonetheless, the result was overshadowed by Telstra's announcement of a AUD 1 billion off-market share buyback. Telstra's off-market share buyback was not entirely unexpected given the company's solid earnings, proceeds from recent asset sales and the free cash flow that is anticipated to materialise over the medium term from underlying operations.

Key Takeaways

- **Solid earnings and recent asset sales have result in excess capital.** Telstra has excess capital as a result of solid operating performances, and recent asset divestments including 70% of the Sensis directories business and the shareholding in CSL New World, Hong Kong mobiles business. Management has assessed the current level of cash reserves as more than is needed by the business in the medium term.
- **The buyback is a prudent use of capital and available franking credits.** The buyback is part of a prudent and logical initiative by Telstra which balances the distribution of surplus capital to shareholders while maintaining an appropriate capacity for future business investment and growth opportunities.
- **The biggest winners from the buyback are superannuation funds, and individuals on a nil tax rate.** Based on Morningstar's analysis, the largest beneficiaries from the buyback are complying superannuation funds, particularly those in pension mode, and individuals on a nil tax rate.
- **Our fair value and investment opinion is unchanged by the buyback.** We retain our fair value estimate of AUD 5.00 per share and narrow-moat rating for Telstra. We view Telstra as overvalued at current levels with the market overly focused on the dividend yield. In our view, Telstra's superior mobile and network infrastructure is a key differentiator from competitors. We continue to expect mobile, network application and services, and digital media to underpin medium-term revenue growth.

Company Mentioned

Name/Ticker	Economic Moat	Moat Trend	Currency	Fair Value Estimate	Current Price	Uncertainty Rating	Morningstar Rating	Market Cap(Bil)
Telstra Corporation TLS	Narrow	Stable	AUD	5.00	5.56	Medium	Reduce	69.18

Buyback Structure and Recommendation

Telstra will buy back up to approximately AUD 1 billion of ordinary shares, representing approximately 1.6% of total issued shares. The buyback is being undertaken as Telstra has excess capital as a result of solid operating performances during the past three years, and recent asset divestments including 70% of the Sensis directories business and the shareholding in CSL New World, Hong Kong mobiles business. Management has assessed the current level of cash reserves as more than is needed by the business in the medium term. Therefore, Telstra is undertaking the buyback as part of a prudent and logical initiative which balances the distribution of surplus capital to shareholders while maintaining appropriate capacity for future business investment and growth opportunities. We believe the buyback program will not hinder Telstra's ability to pay future fully franked dividends, undertake necessary capital expenditure or launch new growth initiatives.

The buyback will be conducted via a discounted tender structure, inviting shareholders to sell some or all of their shares. The buyback price, or final tender price, will be the largest discount, in a range of 6% to 14%, to the market price, which will enable Telstra to purchase the maximum amount of tendered shares for AUD 1 billion. The market price will be determined by the volume-weighted average price of Telstra shares during the five trading days up to, and including, the closing date of 3 October 2014.

Participation in the buyback is not compulsory, and whether shareholders participate in the buyback depends upon their individual investment objectives (income, long-term growth or short-term gain) and individual tax circumstances. Typically, structured off-market buybacks are designed to mainly benefit superannuation funds and individuals on very low marginal tax rates. Based on Morningstar's analysis, this holds true for Telstra's buyback, with the largest beneficiaries being complying superannuation funds, particularly those in pension mode, and individuals on a nil tax rate. We suggest shareholders review the buyback booklet, which will be sent to them by 4 September 2014, and speak to their financial adviser or tax accountant to reach a decision on whether to participate.

Telstra Investment Thesis and Fair Value

The buyback does not impact our fair value estimate of AUD 5.00 per share or our narrow moat rating for Telstra. We view Telstra as overvalued at current levels. Nonetheless, in our view, Telstra's superior mobile and network infrastructure are key differentiators from competitors. We continue to expect mobile, network application and services, and digital media to underpin medium-term revenue growth. Our narrow economic moat is based on cost and scale advantages across the business, particularly in mobile, fixed-broadband and bundling.

Telstra's ongoing traction in product bundling remains a key positive, with the company adding 259,000 customers to fixed bundles in fiscal 2014, taking total bundled customers to 1.9 million. Product bundling can help reduce churn, with customers locked into fixed-term contracts, and increase average spend (revenue) per user, or ARPU. We view bundling as a key point of differentiation in the retail segment. The potential for Telstra to leverage its superior mobile network, exclusive content and entertainment products (Foxtel, IPTV) provides a competitive advantage, in our view. During fiscal 2014, Telstra's national broadband network revenue totaled AUD 640 million, up 60% from the prior year. These high-margin revenue streams will continue to ramp up over the medium term as the fibre rollout gathers pace. In fixed broadband, the number of retail subscribers has increased 7% in the past year, implying market share gains for Telstra. Despite price competition from other service providers, Telstra managed to deliver a 1% increase in retail broadband ARPU to AUD 55, in fiscal 2014. However, mobile substitution continues to weigh on demand for fixed-line services and connections. In recent years margin expansion in Telstra's mobile business has largely been driven by strong subscriber growth. We had anticipated a slight slowdown in the pace of mobile subscriber growth in fiscal 2015 given evidence of more aggressive price-based competition and improved network performance at Vodafone.

Benefits of Not Participating in the Buyback

Shareholders who do participate in the buyback must weight up the benefits between maintaining their current shareholding and the alternative of selling their shares on-market. Those shareholders who do not participate in the buyback will benefit from Telstra's improved earnings per share, or EPS, as the number of shares on issue will be reduced, while earnings will continue to grow. Telstra will cancel all shares acquired under the buyback. We are forecasting Telstra's fiscal 2015 EPS at AUD 32.1 cents, steady on the prior year. However, without the buyback, EPS would be down 1.6% to AUD 31.6 cents. In addition, shareholders who do not sell into the buyback or sell on-market will continue to receive fully franked interim and final dividend payments, which are (on an after-tax basis) higher than the 90-day bank-bill rate.

Scenario Analysis of Participating in the Buyback

Benefits of Participating in the Buyback for a Superannuation Fund in Pension Mode or Individuals on a Nil Tax Rate

Shareholders who do participate in the buyback must remember the buyback price will be lower than the market price by at least 6%, and potentially 14% below, and benefits must be judged in terms of selling on-market. The advantages of participating in Telstra's buyback come in two forms: (1) franking credits attached to the dividend component; and (2) potential benefits of the capital loss, based on the difference between the deemed capital proceeds and cost base specific to the shareholder. Many scenarios are possible, but generally, only superannuation funds and individuals on very low marginal tax rates benefit from participating in the buyback. If Telstra applies the largest discount of 14% to the buyback, primarily superannuation funds in pension mode and Australian individual residents on a nil rate benefit from participating in the buyback.

The Telstra buyback will be constituted an "off-market" buyback under Australian taxation law. The Australian Taxation Office, or ATO, has indicated to Telstra that the capital component of the buyback price will be AUD 2.33 per share. Therefore, the dividend component will be the amount by which the buyback price exceeds the capital component. Our hypothetical scenario, considers a superannuation fund in pension mode, or individual on a nil tax rate. For example, if the buyback price is AUD 5.00 per share (assuming a market price of AUD 5.56 and 10% tender discount factor), the dividend component will be AUD 2.67 per share, and franking credits of AUD 1.14 per share will be attached to the dividend. In this case, the shareholder's assessable income for tax would be AUD 3.81. However, a superannuation fund in pension mode, or an individual that pays no tax on income, will receive the capital component of the buyback price of AUD 2.33, the dividend of AUD 2.67 and, ultimately, the franking component AUD 1.14. The shareholder will receive approximately AUD 6.14 per share, 23%

above our fair value estimate and 10% more than if the shareholder had sold on-market for AUD 5.56 per share. The superannuation fund in pension mode or individual on a nil tax rate is not able to utilise the capital loss as they pay no capital gains tax.

Benefits of Participating in the Buyback for a Superannuation Fund in Accumulation Phase

In our hypothetical scenario, a superannuation fund in the accumulation phase is paying 15% income tax. The buyback price is AUD 5.00 per share (assuming a market price of AUD 5.56 and 10% tender discount factor) the dividend component is AUD 2.67 per share and franking credits attached are AUD 1.14 per share. The shareholder's assessable income would be AUD 3.81 and tax payable at 15% would be AUD 0.57, but offset by the AUD 1.14 in franking credits. The shareholder's net income would be AUD 3.24, comprising the AUD 2.67 dividend plus AUD 0.57 in excess franking credits. The tax offset, excess franking credits, may be applied against other assessable income or, if it exceeds total tax payable, may be refunded by the ATO. Including the capital component of AUD 2.33, the shareholder will receive AUD 5.57 per share before taking into account any capital gain or loss.

The superannuation fund shareholder in the accumulation phase may also be able to utilise the capital loss incurred in accepting the buyback price, depending on the original price paid (cost base) for the Telstra shares. The capital loss is calculated by deducting the deemed capital proceeds from the original share purchase price. In our hypothetical scenario, the shareholder's assumed cost base is AUD 4.00 per share (in the past decade Telstra's share price has traded between a low of AUD 2.55 and high of AUD 5.76 per share). Therefore, the capital component of the buyback price is AUD 2.33 per share plus an adjustment to deemed capital proceeds, under ATO legislation, of AUD 0.56, resulting in deemed capital proceeds of AUD 2.89 per share.

The resulting capital loss from accepting Telstra's buyback price is approximately AUD 1.11 per share, being the original purchase price of AUD 4.00 less the deemed capital component of the buyback price of AUD 2.89. For a complying superannuation fund which holds shares for longer than 12 months, a capital gains tax discount of 33.3% applies, resulting in a capital loss benefit of AUD 0.11 per share, which can be offset against capital gains or, if not used, may be carried forward. The total after-tax proceeds and benefits to the superannuation fund would be net income of AUD 3.24 per share, the capital component of the buyback price of AUD 2.33 per share plus capital loss benefit of AUD 0.11, totaling AUD 5.68 per share. The after-tax buyback proceeds and benefits of AUD 5.68, is 14% above our fair value estimate and 5% more than if the shares were sold on-market for AUD 5.56 per and capital gains tax of AUD 0.16 per share was paid.

Exhibit 1: Hypothetical Telstra Share Buyback Calculations

OFF MARKET SHARE BUY BACK						
INCOME TAX ISSUES	**SMSF**		**Australian resident individuals**			
Tax rate	**15.0%**	**0.0%**	**21.0%**	**34.5%**	**39.0%**	**49.0%**
Buy Back Price	$5.00	$5.00	$5.00	$5.00	$5.00	$5.00
Less: Fixed Capital Component	$2.33	$2.33	$2.33	$2.33	$2.33	$2.33
Assumed Dividend Component	**$2.67**	**$2.67**	**$2.67**	**$2.67**	**$2.67**	**$2.67**
Add: Gross up for Franking Credits	$1.14	$1.14	$1.14	$1.14	$1.14	$1.14
Assessable Income for Tax Purposes	$3.81	$3.81	$3.81	$3.81	$3.81	$3.81
Less: Tax on Assessable Income	$0.57	$0.00	$0.80	$1.31	$1.49	$1.87
Add: Tax Offset for Franking Credits	$1.14	$1.14	$1.14	$1.14	$1.14	$1.14
After Tax Dividend and Franking Proceeds	**$3.24**	**$3.81**	**$3.01**	**$2.50**	**$2.32**	**$1.94**
CAPITAL GAINS TAX ISSUES	**SMSF**		**Australian resident individuals**			
Capital Component	$2.33	$2.33	$2.33	$2.33	$2.33	$2.33
Deemed adjustment to Capital Component	$0.56	$0.56	$0.56	$0.56	$0.56	$0.56
Deemed Capital Proceeds	$2.89	$2.89	$2.89	$2.89	$2.89	$2.89
Less: Cost Base	$4.00	$4.00	$4.00	$4.00	$4.00	$4.00
Nominal Capital (Loss/ Gain)	-$1.11	-$1.11	-$1.11	-$1.11	-$1.11	-$1.11
Discounted Capital (Loss/Gain)	-$0.74	-$0.56	-$0.56	-$0.56	-$0.56	-$0.56
Tax Impact of Capital Capital (Loss)/Gain	$0.11	$0.00	$0.12	$0.19	$0.22	$0.27
Add: Capital Component	$2.33	$2.33	$2.33	$2.33	$2.33	$2.33
After Tax Capital Proceeds	**$2.44**	**$2.33**	**$2.45**	**$2.52**	**$2.55**	**$2.60**
Total After Tax Proceeds	**$5.68**	**$6.14**	**$5.46**	**$5.02**	**$4.87**	**$4.54**

ON MARKET SALE OF SHARES						
	SMSF		**Australian resident individuals**			
Sale consideration	$5.56	$5.56	$5.56	$5.56	$5.56	$5.56
Less: Cost base	$4.00	$4.00	$4.00	$4.00	$4.00	$4.00
Nominal Capital Gain	$1.56	$1.56	$1.56	$1.56	$1.56	$1.56
Discount Capital Gain	$1.04	$0.78	$0.78	$0.78	$0.78	$0.78
Tax On Capital Loss/(Gain)	-$0.16	$0.00	-$0.16	-$0.27	-$0.30	-$0.38
Total After Tax Proceeds	$5.40	$5.56	$5.40	$5.29	$5.26	$5.18
Buy Back	$5.68	$6.14	$5.46	$5.02	$4.87	$4.54
On Market Sale	$5.40	$5.56	$5.40	$5.29	$5.26	$5.18
Difference	$0.28	$0.58	$0.06	-$0.27	-$0.39	-$0.64
	5%	10%	1%	-5%	-7%	-12%

Key Assumptions in Our Hypothetical Scenarios

Our calculations make the following key assumptions:

1. purchase price of shares by shareholder was AUD 4.00 per share;
2. market price is AUD 5.56 per share;
3. discount applied to buyback is 10%;
4. shareholders who successfully sell shares under the buyback acquired the shares on or before 6 October 2013 are be eligible for the discount capital gains tax concession when determining their capital gains tax consequences;
5. shareholders have capital gains to offset the capital loss and the capital gains were derived from assets sold that were held for more than 12 months; and
6. shareholders have held shares at risk for a minimum of 45 days to qualify for the franking credits.

Buyback Process

The buyback involves shareholders participating in the tender process, via specifying the quantity of shares offered and discount to the market price the shares are offered at, or the shareholder may offer to sell at the final price tender. The quantity of shares may be part or all of a shareholding, unless the shareholding is 925 shares or less, then all the shares must be tendered into the offer. Each shareholder who successfully tenders into the buyback is guaranteed that 925 shares will be bought by Telstra and will not be subject to scale back. Additionally, any shareholder who is left with 370 shares or less as a result of the buyback will have their entire shareholding acquired. Effectively, shareholders who hold 1,295 shares or less and successfully tender into the buyback will have all their shares acquired by Telstra. We would advise superannuation funds and individuals on a nil tax rate to consider tendering the full amount of their shareholding.

Shareholders must also specify the discount to the market price the shareholding is being tendered into the offer. Telstra is offering nine discount options between 6% and 14% to the market price. If shareholders have more than 925 shares they may tender at different discounts to the market price. However, the simplest and most straightforward option to increase the likelihood that some or all of a shareholder's holding will be bought by Telstra in the buyback, is to tender all shares at the final price tender. The final price tender is an offer by shareholders to sell their shares at whatever price is ultimately determined by Telstra to be the buyback price. Final price tenders will only be scaled back if the buyback price is set at a 14% discount to the market price and the total number of shares tendered is more than Telstra has determined to buy back for AUD 1 billion. Shareholders also have the option of nominating a minimum price below which they are not prepared to sell their shares. This option is more suited to shareholders on higher tax rates. We would advise superannuation funds, particularly those in pension mode, and individuals on a nil tax rate, to consider tendering the full amount of their shareholding at the final price tender. These shareholders wishing to maintain exposure to Telstra could repurchase shares on-market at a later date.

Appendix I – Key Information

Key Points Under the Buyback

Structure: Off-market discounted tender

Amount: Approximately AUD 1 billion, or approximately 1.6% of issued ordinary shares.

Tender Discount Range: Nine specified tender discounts from 6% to 14%, at 1% intervals, to the market price. The alternative is the final price tender, which is an offer by shareholders to sell their shares at whatever price is ultimately determined by Telstra to be the buyback price. Tenders can also be made subject to four minimum price conditions: AUD 4.15 per share, AUD 4.35, AUD 4.55 and AUD 4.75.

Capital Component of Buyback Price: AUD 2.33 per share

Buyback Price: The price Telstra will buy back shares tendered into the offer. The price is determined by applying the buyback discount selected by Telstra to the market price.

Market Price: The market price will be determined by the volume-weighted average price of Telstra shares during the five trading days up to, and including, the closing date of 3 October 2014.

Minimum Tenders: Shareholders with 925 shares or less must tender all their shares to participate.

Small Holdings: A shareholder tendering all of its shares at a discount equal to or greater than the buyback discount or as a final price tender, who would be left with 370 shares or less, will instead have their shareholding accepted in full.

Eligibility: All shareholders who are the registered shareholders on the buyback record date, 22 August 2014, are eligible to participate in the buyback unless they are ineligible foreign shareholders. Basically, an ineligible foreign shareholder is someone residing in a country other than Australia or New Zealand.

Telstra Share Buyback Calculator: Available on Telstra's corporate website.

Buyback Timetable

Monday 8 September 2014: Tender period opens.

Friday 26 September 2014: Payment of AUD 0.15 fully franked final dividend.

Friday 3 October 2014: Tender period closes.

Monday 6 October 2014: Buyback price and scale-back determined.

Tuesday 14 October 2014: Buyback proceeds paid to successful shareholders and updated holding statements dispatched.