JM Financial Group

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Investment Newsletter

Market Performance (As at 30th April 2017)	Month To Date (%)	Calendar YTD (%)	1 Year Rolling (%)
S&P - All Ords Accum. Index	0.78	5.32	16.65

***Month in Review** – A review of events that influenced the share market in April.*

The ASX 500 Accumulation Index rose a further 0.8% in April, with a calendar year to date return of 5.3% and 1 year rolling return of 16.7%. The Dow Jones continued its march forward, climbing a further 1.3% to finish the month at 20,941. With the exception of the Telecommunications and Consumer Staples sectors, all other Industrial sectors rose in the Australian market, whilst Materials and Resources related sectors all fell. The Gold sector had the largest fall, -2.5%, despite a 2.9% rise in the A$ gold price over the month. Newcrest Mining announced during the month that FY17 production would be at the bottom end of the range.

In the Consumer Staples space Coca-Cola Amatil downgraded volume expectations during the month while Wesfarmers came under pressure following strong quarterly sales from Woolworths' supermarket division. The Telco sector tumbled when it was announced that TPG had won a spectrum bid and would start a fourth mobile network. Telstra fell 9.4% for the month, TPG Telecom fell 14% and Vocus Communications fell 22%. The combination of a fourth mobile network and ongoing rollout of the NBN equates to substantially expanded capacity, which will no doubt be good for the consumer, but in all likelihood will see an erosion of Telstra's high margins and see a new level of competition emerge. This could well be a tough space to find excess returns for some years to come, unless a degree of industry consolidation occurs.

Iron ore finally took a steep fall, having been quite resilient in the first quarter of CY17. The iron ore price fell from around US$87/t to sub US$70/t. BHP and RIO were off only marginally, essentially their share prices had not built in the iron ore prices holding above US$70/t for any length of time. Energy prices were generally flat over the month.

The estimated Market PER multiples for ASX 200 is around 16x based on forward 12 month estimated earnings. This compares with a recent peak forward PER multiple of 17x in July 2016, as per the chart below.

Chart of the Month – Next 12 Month PER, ASX200 vs ASX Small Ords

This month we compare the PER's of the ASX 200 and ASX Small Ords, based on the rolling estimated 12 month forecast earnings for each index over the past five years.

The chart highlights several points over the last 5 years where the Small Ords has been expensive relative to the ASX 200. These include the latter half of CY13, through parts of CY14, and through the middle of CY16.

Excluding the lower multiple Financials Sector, which accounts for 39% of the ASX 200 and currently trades on a forward 12 month PER of 14.5x, we estimate the remaining 61% of the market trades around 17x forward 12 month PER. If we also exclude the Materials sector which trades on 13.1x forward 12-month PER, a sector which comprises 15.5% of the ASX 200 and is dominated by BHP and RIO, the remaining 45.5% of the market trades on a forward PER slightly above 18x.

The ASX Small Ords does not appear expensive on a relative basis. However that is dependent upon Small Ords earnings forecasts being achieved. With confession season typically beginning in May, the next couple of months may be critical in supporting/negating that view.

Due Diligence – *Telstra*

Telstra is under siege. Fixed line revenues continue to be under pressure, as they have been for the last decade and more. However mobile revenues, once the offset to falling fixed line revenues, can no longer be relied upon. For the last two halves Telstra's Mobile revenues have been in decline.

Part of this relates to reductions in mobile termination rates, which have a partial cost offset. However core post- and pre-paid monthly mobile revenues and mobile broadband revenues have been in decline. While handset numbers continue to rise, monthly pricing is under pressure and at the same time greater monthly capacity is being offered. Competition is having a profound impact and with TPG Telecom's announcement to start a fourth mobile infrastructure network, the competitive environment is likely to get worse.

Product framework - income

Income	1H16[1]	1H17	GROWTH (reported basis)	GROWTH (reported basis)	GROWTH (ex-MTAS & FAD[2])
Mobile	$5,524m	$5,043m	-$481m	-8.7%	-2.4%
Fixed excl. nbn C2C[3]	$3,517m	$3,304m	-$213m	-6.1%	-5.2%
Recurring NBN DA	$186m	$212m	$26m	14.0%	
Data & IP	$1,434m	$1,374m	-$60m	-4.2%	-3.4%
NAS	$1,250m	$1,475m	$225m	18.0%	
Global connectivity	$716m	$704m	-$12m	-1.7%	
Other core[4]	$716m	$778m	$62m	8.7%	
Recurring core	**$13,343m**	**$12,890m**	**-$453m**	**-3.4%**	**-0.4%**
One-off NBN DA and nbn connection	$349m	$719m	$370m	106.0%	
New business[5]	$110m	$94m	-$16m	-14.5%	
Total Guidance and Reported	**$13,802m**	**$13,703m**	**-$99m**	**-0.7%**	**2.2%**

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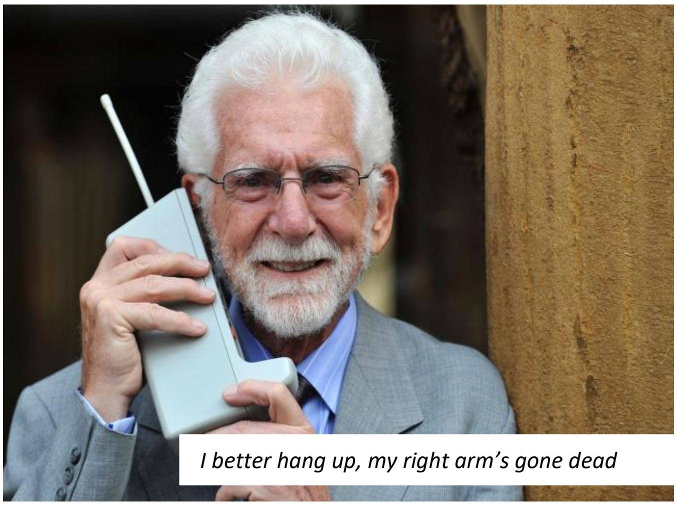
Telstra is cutting operating expenses but investing more in capex. Earnings are likely to keep deteriorating, with a further once-off step down post 2020 when current NBN payments to Telstra cease. Underlying consensus EPS is forecast to fall to ~25c post 2020 and dividends to a similar or lesser amount. At that point Telstra would be trading on ~16.5x and yielding less than 6.0%. However, there remains much uncertainty – the fourth mobile network could have a far more damaging impact. Alternatively TPG Telecom could be acquired by a competitor, most likely Vodafone, in which case the fourth network may never emerge. Overall the balance of risks looks to be on the downside and a PER of 16.5x post 2020 looks expensive. The only support for Telstra is likely to be its yield, but this makes a very limited argument to justify an overweight portfolio position.

Data, Data and More Data

The Telecommunications industry has come a long way since the first mobile system began in Melbourne in August 1981. At that time a mobile phone was limited to a $5000 car phone, weighed 14 kilograms and stored 16 numbers. Coverage expanded to all capital cities in 1985. Australia's first hand-held mobile call did not occur until February 1987 and phones at that stage resembled bricks, cost more than $4,000 and could only make phone calls. Move forward 30 years and Australia has 3 broad coverage mobile networks with a fourth recently announced by TPG Telecom, multiple resellers and data allowances that are ever expanding. The pervasiveness of mobile communications is easily seen when riding public transport, where barely a newspaper is seen today.

With a fourth mobile network currently in the wings and ever increasing capacity and speed on existing mobile networks, one has to wonder where this ultimately leaves the NBN – no doubt our insatiable desire for capacity will find a use for it.

Mobile data is increasingly becoming a commodity, and with that one should expect network returns to marginalise. TPG Telecom purchased two 10MHz blocks of spectrum in the 700MHz range and will progressively roll out a network covering 80% of the population by 2020. A fourth mobile network in Australia is not a new occurrence; prior to Vodafone merging with Hutchison in Australia in 2009, Hutchison lost many hundreds of millions in the Australian market despite a customer base in excess of 2 million at December 2008.



I better hang up, my right arm's gone dead

What TPG has that Hutchison did not is a broad communications offering built on fixed-line data services, including calls, along with mobile reselling arrangements utilising the Vodafone network. Nevertheless its move into mobile infrastructure raises the risk profile for telecommunications operators in Australia and a degree of caution in the sector is warranted. The consumer should be a major beneficiary.

If the TPG network goes ahead as planned, Vodafone is likely to be the major loser, with an immediate transfer of customers off the Vodafone network and onto TPG's network as it is progressively built. But the pricing impact will affect all operators. Arguably Telstra will be least affected as its premium offering reputation, with broader and faster coverage, should provide some protection for its customer base that is typically less price sensitive than existing Optus and Vodafone customers.

Technology – where to next?

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