Telecom Corporation of New Zealand

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TEL AUD $2.11 Core **MED.** **B**

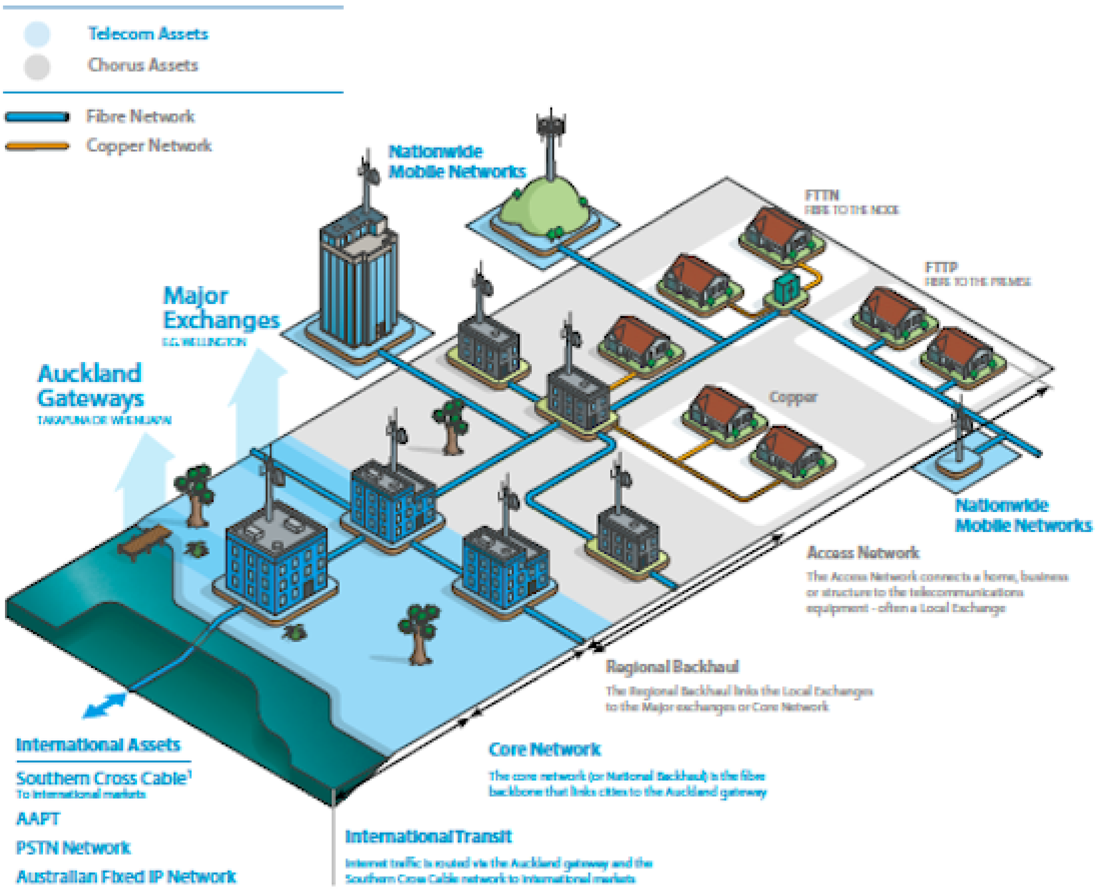
A Kiwi yielder with potential catalysts

We believe that Telecom New Zealand (ASX: TEL, NZX: TEL) is in the relatively early innings of a turnaround story. The company was demerged from network services operator Chorus in 2011 and has endured somewhat of a challenging time since the split. However we are encouraged by a number of initiatives which are taking place to restore the company to being a more competitive commercial enterprise.

Management are making inroads into the cost base whilst 4G expansion will provide an additional avenue for earnings growth. These factors, combined with a favourable valuation compared to peers and a solid dividend should see a renaissance of interest in the stock in our view.

As the company is a very different beast to its original structure, **lets take a quick look at how Telecom is structured past-Chorus.** The demerger of Telecom and Chorus took place in late 2011 and bought about a split in network assets.

Telecom retained nationwide mobile networks, PTSN equipment for fixed line calling, and international assets such as AAPT, a fixed IP network in Australian and 50% stake in the Southern Cross international cable. The following schematic highlights the split of assets between the two companies post-demerger, with Telecom assets shown in blue shading:

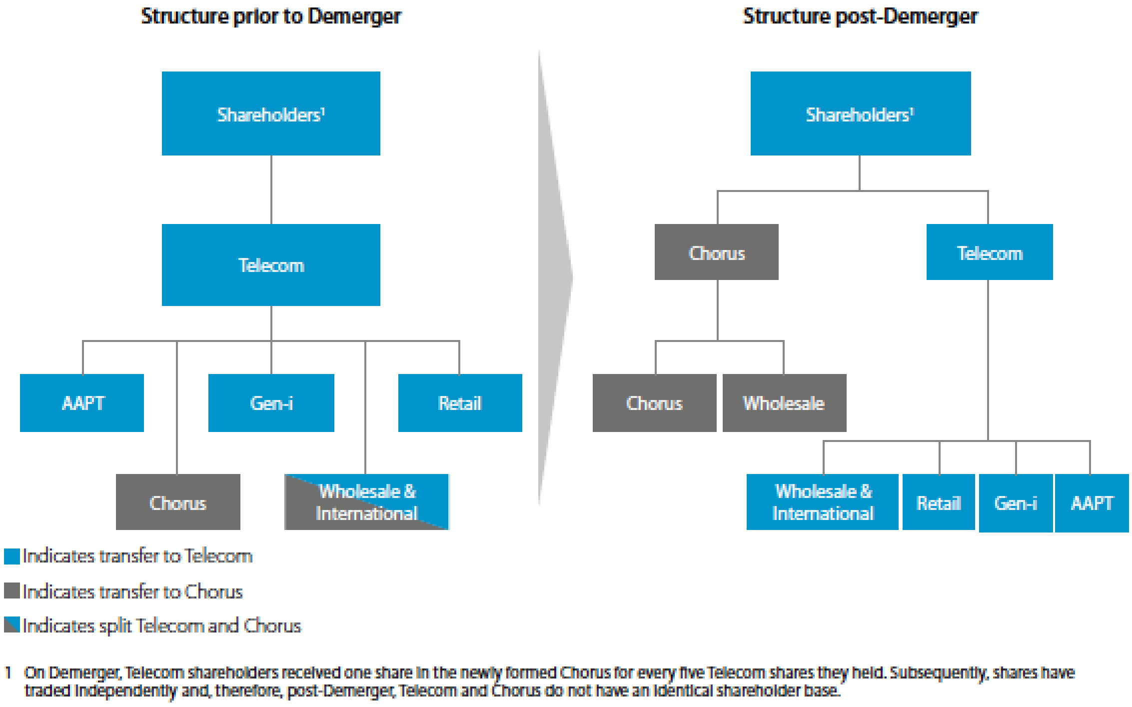


Source: Telecom NZ Annual Report 2012

To provide some additional flavour on these assets, **in New Zealand the company has retained a significant mobile tower footprint,** which has 97% coverage across the New Zealand population. It also has a national backhaul fibre network and service platform for voice and data applications, which include 30 major exchanges and two Auckland gateways.

Internationally the company's **50% interest in the Southern Cross International cable network encompasses 28,900km of submarine cable** that secures bandwidth for Australia, New Zealand, Hawaii and the USA. In addition 1,600km of terrestrial cable and 9 cable stations. In Australia it owns 11,000km of interstate fibre, with data centres in the major capital cities and 200 exchanges with mid-band Ethernet.

The company reports across four customer-facing business units, supported by a central product group, network and IT unit, and a corporate centre (management). The four customer-facing units are reported as shown in the diagram (in blue) below beginning with the Wholesale & International unit, Retail, Gen-i and finally AAPT.



Source: Telecom NZ Annual Report 2012

The Wholesale & International segment owns the national backhaul assets and PTSN network and provides voice, mobile, interconnection, managed data to approximately 70 service providers. International provides integrated telecommunications between New Zealand, Australia and globally. The segment generated about NZ$154 million in EBITDA in FY2012.

The Retail segment generated the most EBITDA for the company in 2012, chipping in NZ$506 million. The business provides mass-market products, services and support to consumers and SME customers. This could be fixed line calling and access, broadband, dial-up, mobile and multimedia service. The segment has retail locations throughout New Zealand.

Gen-i provides ICT solutions to Telecom's business customers across New Zealand and Australia, with services focused on networked IT and managed solutions in fixed and mobile. The segment generated circa NZ$263 million of EBITDA in 2012.

Finally AAPT is an Australian telecommunications provider of voice, data and internet services to Australian consumer, business and wholesale customers. The segment generated a relatively modest NZ$88 million of EBITDA in the 2012 fiscal year.

The rapid increase in price has resulted in the RSI to move into overbought territory, which is suggestive of a short term correction at hand. Firm support is expected at the $1.975/$2.00 region should this scenario unfold.

Telecom looks to trim down

At the time of Telecom's 2013 half-year profit announcement, the company advised that it would book some material one-off costs in the second half of the 2013 fiscal year to make structural and portfolio changes that would simplify and make its business more competitive on the cost side.

A more recent announcement (28 March 2013) gave some additional colour on the company's plans. **New CEO Simon Moutter is in the midst of a strategic shift for the company and stripping out some fat is on the agenda.** Telecom expects to incur one-off restructuring costs of NZ$70 million to NZ$80 million in FY13 to reset the scope of Gen-i Australia and downsize in New Zealand, particularly in corporate centre functions such as management, HR, Finance, Legal and Corporate Relations.

The flow on impact of these changes on revenues and non-labour operating costs is still relatively uncertain, although **Telecom has said at the first brush it believes payroll costs will fall by NZ$90 million to NZ$110 million on an annualised basis.**

Telecom expects to incur further redundancies and other one-off costs down the line as it works through the remainder of its strategic change process and will provide a further update later this year. As part of this overall process, Telecom has stated that it will significantly reduce headcount at the business.

Headcount is anticipated to decline from 7,530 full time equivalent employees at 31 December 2012, to about 6,300 to 6,500 by the middle of this year. The company is looking to reduce staff levels by putting constraints on new recruitment activity, voluntary and involuntary redundancies and the transfer of roles to other employers associated with portfolio rationalisation decisions.

We expect to get more clarity on the strategic process going forward, likely in May from CEO Simon Moutter. For instance, the impact of the changes on revenues and non-labour costs is at present uncertain.

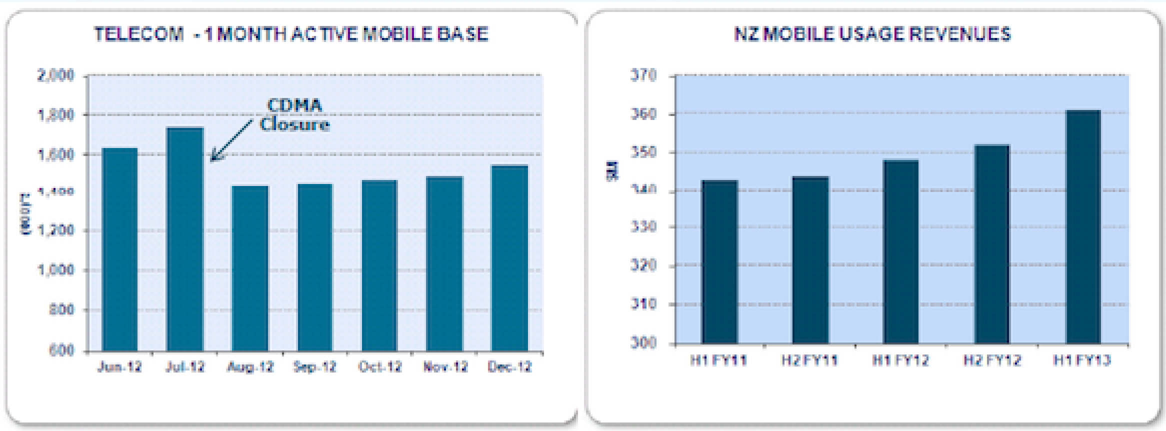
The company has maintained its adjusted EBITDA guidance of NZ$1,040 million to $1,060 million, excluding the one-off restructuring costs to implement the cost out strategy. CEO Simon Moutter said in a statement regarding the strategy, “This is an important step to build a leaner, more agile organization with a competitive cost structure, setting us up to win in the market.”

Seeking to upgrade the customer experience

Telecom operates in an extremely competitive space **so are planning to roll out the 4G LTE service on its Smartphone Network in Auckland by October, then extending it to Wellington and Christchurch by Christmas.** The next calendar year the target would be to have 4G LTE on close to half its nationwide Smartphone Network.

In mobile the company lost some of their overall customer base with the closure of the legacy CDMA network last July but **had strong net additional connections (+103,000) from August** following the introduction of a new budget pre-paid pack and flanking brand, ‘Skinny’, resonating well with younger users.

Mobile is a competitive space but the company is seeking to grow its market share and stimulate usage revenues. They have made some progress on both fronts as can be seen below:



Source: Company presentation

On the broadband side the company have sought to stabilise their market share in the first half of 2013 with some sharply priced offers. Over the half year the company acquired a new 13,000 additional customers ahead of the rollout of the ultra-fast broadband (UFB) product offering. Telecom announced the launch of its UFB product late March with an entry-level residential 50GB package for NZ$95 per month based on a 12 month contract.

The roll-out of UFB to 75% of New Zealanders by 2020 is a Government-led initiative with four UFB partners currently installing fibre across the country. It was this initiative that led to the demerger with Chorus. It has some similarities to the Australian National Broadband Network (NBN).

However at the group level there are plenty of challenges that remain. Fixed line is in what we would describe as structural decay as we move towards a mobile world and margins on entry-level broadband are thin, creating a drag on group margins.

Telecom is not overly burdened with debt, carrying total short and long term debt of NZ$1.2 billion at 31 December 2012, with debt due within one year totalling NZ$405 million. With a closing cash position of NZ$311 million and net operating cash flows during the six months of NZ$424 million, the balance sheet is on a firm footing.

In terms of valuation, Telecom is currently trading on 14.3 and 13.7 times consensus earnings estimates for June 2013 and June 2014 respectively. The stock is also supported by a solid dividend with expectations of yield over that same period equating to 6.3% and 6.4% respectively. On an EV/EBITDA multiple basis Telecom trades on 5.3 times 2013 estimates. Telecom declared a NZ$0.08 half year dividend and bought back shares to the tune of NZ$114 million in the six months ending 31 December 2012.

This compares to Telstra's modestly more expensive price to earnings multiples of 15.9 and 15.4 times and dividend yield of 5.9%. On an EV/EBITDA multiple basis Telstra trades on 6.8 times 2013 estimates. We view Telstra as the superior business and worthy of a premium over Telecom, but believe Telecom has the potential to become a more competitive business given the changes afoot.

With reference to the weekly chart, prices are largely contained within a broad consolidation between support at $1.44 and resistance of $2.31. A decisive break above the upper boundary would trigger a strong boost of upward momentum to follow, and thus would likely lead to further gains to be had over the longer term horizon.

Overall we believe that Telecom New Zealand (ASX: TEL) offers members another solid yielding candidate with several potential catalysts to the upside. **Therefore we recommend Telecom as a buy to Members around A$2.11.**

New Zealand based investors can buy the stock (NSX: TEL) on the NZX around NZ$2.62.

Snapshot TEL

Telecom Corporation of New Zealand

Spark New Zealand (formerly Telecom New Zealand) is a supplier of telecommunications and information, communications and technology (ICT) services in New Zealand and Australia. Telecom provides a range of telecommunications and ICT products and services, including local, national, international and telephone services; mobile services, data, broadband and Internet services; information technology (IT) consulting, implementation and procurement, equipment sales, and installation services. The Company's portfolio of IT services includes cloud computing services, managed IT services, IT outsourcing, IT software and hardware procurement, and professional services to assist organizations with business and technology investments.

The company was rebranded from Telecom to Spark in August 2014.

Market Capitalisation:$4.0b

	FY1	FY2
Price to Earnings	15.9	15.4

Dividend Yield (%)	6.3	6.4
Return on Equity (%)	21.2	21.7
EV/EBITDA	5.3	5.3