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Is NBN uncertainty causing a downturn in Australian Telcos stocks?

The Telco sector suffered in 2017 compared to an overall buoyant Australian sharemarket and many investors are pointing the finger at the rollout of the NBN.

There's no doubt that Australia needs to update its Telco infrastructure, so that we can participate in the digital economy of the future. We continue to lag almost all developed (and even some developing!) countries when it comes to broadband speeds. We're even behind Kenya and Hungary!

However, having the Government responsible for upgrading the national network has been a difficult journey. A better option may have been New Zealand's private sector engagement model, where the government works in partnership with the private sector.

By my estimation, the NBN will never earn a financial return-on-investment for its owner, the Federal Government. I would not be surprised if there was a significant write-down of the investment at some point in the future.

Australia needs to strike a balance between an NBN that's affordable, and yet can provide what is needed. While some are criticising the continued use of copper wire transmission, instead of fibre optic cables, it's important to remember that the speeds you can get on copper are adequate for most users, can be upgraded over time, and come at half of the cost of fibre.

While 5G technology is on the way, it is hard to know exactly how technology will evolve. It is likely that there will always be a small percentage of users who can make do without a broadband connection – as there are now. However, it will be a long time before mobile networks can fully replace broadband supplied by a landline, like a copper network or the NBN.

With the rise in the popularity and use of services such as YouTube, Netflix and Stan, people are watching more video online, and this consumes huge amounts of data. Foxtel now streams online, and free-to-air TV is moving in this direction too.

The average broadband user uses 150Gb per month, whereas the average mobile user uses 3Gb per month. In other words, mobile networks would need to improve at least 50-fold to catch up and this seems unlikely to happen quickly.

So what is the impact of the NBN on Telco stocks?

The roll-out of the NBN has really changed the playing field and reduced the barriers to entry for fixed line services. There are now over 180 internet service providers all competing for customers.

Industry profit margins in landline internet are shrinking quickly as all players push hard for market share - with the NBN migration being seen as a 'once in a generation' opportunity to entice customers away from competitors.

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As customers are forced to move to the NBN, many Telco providers are looking to lock-in new subscribers for the long term, and the NBN migration is certainly an opportunity for many smaller telcos to do that.

However, we need to remember that the Top 4 players have over 92 per cent market share, and while they are still winning most customers, they are reducing their profit margins in order to maintain this share. It is difficult to estimate at this stage when, if ever, they will be able to increase those margins again.

As the last customers migrate onto the NBN in June 2022, I would expect to see some industry consolidation, with the 180 current providers shrinking to around 25. Some will be bought out by large competitors, while others simply won't achieve enough market share and will disappear.

In our view, this industry consolidation could be a repeat of what occurred during the pre-NBN copper broadband era, where significant acquisition activity occurred. We saw M2 buy Dodo and Primus. Vocus has since bought M2. iiNet bought Netspace, AAPT, TransACT, Internode, and Adam Internet, before TPG bought iiNet.

So investors need to be very selective when looking to invest in the Telco sector, and have to focus on those that have a real, long-term competitive advantage, recurring earnings and the potential to grow over time.

What's ahead for the Telco sector?

The Telco sector is an industry in transition, and we expect that the market will continue to be volatile. Over the coming year, the NBN market will continue to be very competitive. 2018 is a big year for the NBN roll out, with about 25 per cent of Australia's homes to transition to an NBN connection over the coming 12 months.

In this environment, our focus remains on those Telcos with a long-term competitive advantage and recurring earnings that will allow them to grow over time, providing an absolute real return and regular income for our investors. While uncertainty exists, IML are comfortable with our holding in Telstra and have been adding in weakness to our position recently.

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