New Zealand Commerce Commission

Submission on Fibre input methodologies

Initial value of financial loss asset

New Street Research, Australia and New Zealand

About New Street Research

New Street Research (NSR) is the leading global independent research house in the telecom, cable, towers and satellite space. We provide specialist research on these sectors to equity and debt investors in global capital markets. We write research on over 150 companies in the sector across the globe as well as reports on major industry developments including regulation and emerging technology such as 5G. In relation to New Zealand we write research for global investors on Spark, Chorus, Vocus and Vodafone NZ, although we don't have formal research coverage of Vocus or Vodafone New Zealand.

New Street has over 200 institutional investor clients globally. Our research is produced by a team of over thirty analysts with extensive experience in the telecommunications sector, based in London, New York, Singapore and Melbourne. Our research is differentiated by being idea driven, based on independence of thought and firmly focussed on fundamentals and valuation.

We make three points in this submission:

- Crown financing imposed material obligations on, and risks for, both Chorus as a group and non-CFH investors, through the loss making period.
- Chorus's WACC is around 5.5% to 6.0% and we think is similar to and possibly less than that for any separable UFB component given potential variation in expected cash flow. The WACC for the financial loss asset (FLA) asset would be higher given greater uncertainty over outcomes over the past nine years. Chorus's asset beta is well above 0.6 and may be over 0.7.
- There is likely to be significant ongoing investment in fibre and wireless networks and related assets in New Zealand through a period of 'digital densification' through the 2020s to which global investors will benchmark risks and returns with Chorus's regulated assets. Achieving outcomes in the

long-term benefits of end-users requires appropriate consideration of risks faced by investors in those regulated assets.

As a general point we consider the long-term benefit of end-users (LTBE) of telecommunications services is enhanced where investors have confidence in the underlying regulatory model as this has a significant impact on investor perceptions of related investment risk which in turn affects the cost of capital. We think this calls for a high degree of rigour and consistency in such regulation. In particular, we are concerned that key factors that affect regulated outcomes are consistent on an ex ante and ex post basis notably crown financing risks, and key cost of capital parameters including asset betas.

Obligations imposed by Crown financing are a material additional cost to Chorus, and in particular to non-CFH investors, reducing the benefit of Crown financing

We are concerned that the Commission has changed its view on the obligations on, or risks faced by, Chorus is relation to Crown financing and now considers the benefit of Crown financing is equivalent to the regulatory WACC. The previous draft decision made some minor allowance for related risk by reducing the regulatory WACC by 25 basis points. We viewed this as a modest concession rather than a considered view.

Crown financing has priority over other financing, respectively for each of debt and equity financing. By definition that implies greater average cost of capital across other capital investors. It may be the case that the Commission is considering the WACC across the whole group of financing sources but as with any incremental finance decision the impact of incremental financing cost including related risk is on the established investors, in this case on non-Crown financing sources. That is to say your decision on the appropriate regulatory WACC across the group will affect non-Crown financing sources much more than it will affect Crown financing sources, if it affects Crown financing at all given the protections it holds.

In any case, even across the total group of financing there is a clear material increment to risk across the group as a result of the “unusually onerous conditions” to which Chorus is subject by the terms of the Crown finance.

These obligations and conditions were weighed and considered by non CFH capital investors prior to Telecom agreeing to the UFB terms including structural separation. They continued as a consideration by investors through the UFB build period.

The UFB Initiative and Agreements with Crown Fibre Holdings were considered so significant to shareholders consideration and eventual agreement with the UFB arrangements that they formed a separate section of the demerger documents of September 2011. Among other things, these additional risks faced by non-CFH investors and which added to Chorus’s overall risk profile include:

- The establishment of Chorus in an Initial Period Agreement in such a way as to not materially adversely affect CFH’s rights, or Chorus’s ability to perform

any material obligations under the Agreements. In other words, even the initial establishment of Chorus gave priority to CFH over other capital investors.

- Initial leverage obligations, regardless of whether these best suited other capital investors.
- Possible payment of liquidated damages to CFH if performance milestones are not met.
- Possible service default payments if agreed service levels were not met.
- Dividend stopper arrangements.
- Dispute resolution arrangements specific to the UFB.
- Potential payment of liquidated damages, and other potential damages claims.
- Potential loss of management rights in certain circumstances of performance failure, including potential loss of day to day management control.

(Source: Chorus, Telecom NZ demerger document, Section 4, pp 82 - 91.)

And as to our previous point on separability of financing risk, the requirements were considered separately and distinctly by non-CFH investors from whatever consideration was undertaken by Crown Fibre Holdings.

A key indication of the different level and form of risk faced by CFH and non-CFH investors is in the substantial forms of governance imposed on Chorus by the agreement including Relationship Managers, Project Control Groups, Steering Committees and Senior Committees. Chorus was required to consult with CFH on key appointments and CFH was entitled to nominate an independent board member. Chorus was required to meet certain expenditure obligations in relation to the UFB, and have such expenditure vetted by the Senior Committee. Chorus was subject to dispute resolution arrangements specific to the UFB.

Chorus was also required to enter into a Deed of Operational and Governance Undertakings “in favour of the Crown”.

These arrangements aided CFH in managing risks in its favour relative to the rest of the group. They also imply a higher level of perceived risk across the group as a result of the UFB agreement.

Any other investor (at that time and while there were risks to UFB being completed) would rightly consider these to be very favourable terms for the Crown with quite distinct performance rights and protections. They are far more beneficial to the Crown than would apply ordinarily to any debt provider.

We consider and we think any informed investor would consider that these obligations impose a material actual cost on Chorus which should be discounted from your assessment of the benefit of Crown financing.

We are concerned that the Commission no longer seems to recognise the issue of incremental benefit/cost much less give it consideration. And we are concerned

that it has backpedalled from a previous recognition of incremental benefit/cost without any evident consideration.

Cost of capital and asset beta

For the purposes of advising institutional investors we value Chorus and set our 12 month price target on the basis of benchmark valuations including EV/EBITDA multiples and dividend yield. We also do discounted cash flow (DCF) analysis primarily to provide a framework for our benchmark valuation including long term EBITDA, operating cash flow and capex forecasts.

For Chorus we currently use a WACC of 5.6% including an asset beta of 0.7 across the whole group including UFB and copper-based cash flow streams.

This is the lowest WACC we use across all of the Australian and New Zealand telecommunications companies on which we provide research reflecting a relatively more secure and reliable cash flow outlook as UFB approaches completion. (We recently advised our clients that NBN Co's implied WACC was indicated at 5.5% in the company's 2019 annual report which we thought "reflects a lower bound given the difficulty of evaluating risk facing a government business enterprise".)

Beyond regulation key risks to future cash flow streams include ongoing changes in fibre penetration rates and rivalry with wireless access including mobile and fixed wireless, which appears moderate at present but may vary in future.

To the extent it is separable, a group-wide WACC of 5.6% implies a comparable WACC for UFB given the expected contribution of future cash flow. If it was somewhat below the group WACC it would not be far below given the bulk of forecast cash flow is driven by regulated fibre. Indeed there may well be more uncertainty about the cash flow path and variability of cash flow from copper-based services than is the case for fibre, although some of that additional variation may impact the UFB cash flow profile for instance if there is faster or slower migration from copper to Chorus fibre.

In relation to the WACC proposed for the financial loss asset (FLA) we consider the asset beta is well above 0.6 currently and we think likely to be close to or above 0.7. Our Chorus WACC has reduced over time as benchmark rates have reduced and the long term cash flow outlook has become more reliable as UFB completes, capex reduces and fibre penetration becomes more established. And, from an investor viewpoint, risk reduces with progress toward a UFB regulatory arrangement within a defined setting. For instance we modelled a WACC of 8.5% for Chorus in 2016, and 9.5% prior to that. We consider the asset beta was materially higher than 0.7 at the commencement of the build and reduced as build progressed.

Looking back over nearly nine years of research coverage of Chorus it is evident that there has been a wide variation in forecast earnings and cash flow as a result of the UFB agreement, with perceptions of risk varying from time to time as events unfolded and perceptions of risk varied.

In particular the copper price benchmark process between 2012 and 2014 imposed considerable additional burden and risk on Chorus investors. As a result of that outcome, even though it was subsequently wound back, equity investors were required to forego a dividend for two years, in effect subsidising equity for a period to support the UFB obligations. On the face of it that may appear to be an outcome of copper related cash flow but the outcome was a result of the UFB Agreement, meeting UFB obligations and it impacted the source and cost of Chorus's UFB funding.

Significant ongoing investment expected in next generation networks including converged fixed and wireless networks, requires an efficient benchmark cost of capital

Even after the completion of UFB investment we anticipate significant ongoing investment and investor interest in the telecommunications sector in New Zealand. 'Digital densification' is likely to be a key trend in New Zealand as elsewhere with deeper reach of fibre and wireless access to many more access points than c1.8m UFB premises.

Chorus has indicated an ongoing maintenance capex of NZ$200m pa as well as potential further investment in fibre connectivity to 'smart locations' and wireless access points. We expect a comparable level of capital investment from Spark and Vodafone NZ, as well as substantial investment from Vocus, 2degrees and others.

The regulatory model established for UFB will set an important benchmark for such investment and help guide the extent to which network investment may be complementary (for instance, supporting converged fixed and mobile connectivity) or competitive encouraging a productive level of rivalry between network players.

As well it is likely to influence the mindset of key decision makers behind those investments. To what extent will they be encouraged to assess and manage risk in investing in their own infrastructure? To what extent will they be encouraged to rely on regulated access to established infrastructure in which they have no direct investment risk?

We think getting the balance right between these build and buy decisions and regulated and unregulated assets is a key driver of New Zealand's telecommunications outcomes in the 2020s. To the extent it provides a benchmark and informs investors about the impact of regulation on outcomes, the long-term benefit of end-users is best served if those investment decisions are guided by UFB pricing based on commercial asset values and cost of capital.

We expect this point would also be relevant to your forthcoming consideration of what services should be included in the scope of RAB regulation. We see no merit and great risk in including in the scope of RAB regulation fibre services which are only at a formative stage and which may well be provided by a range of rival market players.

We have promoted both Chorus and Spark to global investors as a model for infrastructure investment (with the notable exception of the benchmark copper pricing process in 2012-2014), and to a lesser extent Vodafone and Vocus. As a somewhat circular matter we consider the cost of capital investors consider in relation to certain investment in New Zealand reflects their views of New Zealand's infrastructure regulatory model.

In the case of both the asset beta and the cost to investors of crown financing we are concerned that investors will consider that a certain commercial approach was taken ex ante, that is before investment commitment was made, and a very different approach applied ex post, that is after the investment commitment.

Ian Martin
Senior Telecommunications Analyst

New Street Research

UK FCA FRN 225092

New Street Research LLP. 52 Cornhill, London, EC3V 2PD Tel: +44 20 7375 9111

Ian Martin AR 1236170 of Peak Investment Partners Pty Ltd AR of Peak Investment Holdings Pty Ltd AFSL 304008

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