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Stock Rating
Underweight

Industry View
Cautious

Telstra Corporation

Overcoming FTTN Uncertainty

Conclusion: Telstra, as an integrated telco, continues to face various operational, transformation and regulatory uncertainties in the near term. The debate on fibre-to-the-node investment might also not be resolved any time soon due to disagreements on access prices.

- The economics of FTTN are reasonably weak for Telstra, as (a) there is limited *incremental* ARPU; and (b) it will cannibalize its existing fixed-line revenues. Based purely on *incremental* return analysis, we estimate the FTTN investment is unlikely to generate a positive return in the first three years of investment.
- Alternative carriers also cannot make this investment without Telstra's co-operation, as issues like sub-loop unbundling, co-location and backhaul are complex, costly, and require access to Telstra's networks.
- Another emerging risk is if ALP wins the next election and implements an '*open-access*' broadband framework, we estimate ~A$600-900mn in revenues are at risk.

A possible way of overcoming this investment, operational, and regulatory uncertainty, could be to *structurally* separate the Networks and Services business, in our view. Similar to our TCNZ analysis in May this year – we estimate this could result in ~20% upside to our base-case valuation, or ~10% upside to the current share price. *There is no political will at this point to review this scenario; however, a change of government at the next election could be a catalyst to revisit this debate.* A vertical split of an integrated carrier like Telstra would be unprecedented and a complex exercise. A number of different structures are possible, with varying valuation outcomes.

We have made no changes to our earnings forecasts, and maintain our Underweight call. In view of the current structure, we do not believe the stock is cheap at 15.9x F2009e earnings. The risks in the near term remain high – especially with rising competitive pressures and possible delays in transformation benefits.

Key Ratios and Statistics

Reuters: TLS.AX Bloomberg: TLS AU
Australia Telecommunications

Price target	A$3.94
Shr price, close (Sep 20, 2007)	A$4.40
Mkt cap, curr (mn)	A$54,750
52-Week Range	A$4.97-3.52
Sh out, basic, curr (mn)	12,443.1
EV, curr (mn)	A$68,540
Net debt/cap (08e) (%)	53.6
ROE (08e) (%)	29.0
Shrs out, basic, per-end (08e) (mn)	12,443
S'hldr eqty (08e) (mn)	A$12,243
RNOA (08e) (%)	16.8

Fiscal Year (Jun)	2007	2008e	2009e	2010e
ModelWare EPS (A$)*	0.30	0.29	0.28	0.29
EPS, basic, rpt'd (A$)	0.26	0.27	0.27	0.28
Revenue, net (A$ mn)	23,950	24,434	24,864	25,127
ModelWare net inc (A$ mn)	3,716	3,573	3,447	3,612
P/E	15.4	15.3	15.9	15.2
P/BV	4.6	4.5	4.5	4.5
EV/EBITDA	6.8	6.7	6.7	6.6
Div yld (%)	6.1	6.4	6.4	6.4

***** = Please see explanation of Morgan Stanley ModelWare later in this note.
e = Morgan Stanley Research estimates

Telstra Financial Summary

Exhibit 1

Telstra Financial Summary (Year End June 30)

Income Statement	2006	2007	2008E	2009E
Sales	23,043	23,950	24,434	24,864
EBITDA	9,551	9,858	10,054	10,220
EBITDA normalised	10,241	10,208	10,304	10,370
Depreciation	3,174	3,344	3,226	3,359
Amortisation	904	738	804	849
EBIT	5,478	5,769	6,025	6,012
EBIT normalised	6,590	6,416	6,275	6,162
Interest expenses	(933)	(1,087)	(1,171)	(1,237)
Pretax profit	4,545	4,682	4,854	4,775
Pretax profit normalised	5,657	5,329	5,104	4,925
Tax	1,381	1,417	1,456	1,432
Minorities	0	0	0	0
Net profit	3,164	3,265	3,398	3,342
ModelWare Net Income	3,943	3,726	3,573	3,447

Ratios	2006	2007	2008E	2009E
Normalised Growth (%)				
Sales	2.4%	4.3%	2.3%	1.8%
EBITDA	-3.1%	-0.3%	0.9%	0.6%
Operating profit	-7.0%	-2.6%	-2.2%	-1.8%
NPAT	-11.1%	-5.5%	-4.1%	-3.5%
Profitability (%)				
EBITDA	45.1%	43.1%	42.6%	42.1%
Operating profit	29.0%	27.1%	25.9%	25.0%
NPAT	17.4%	15.7%	14.8%	14.0%
ROE	29.8%	29.3%	28.5%	27.8%
ROA	18.5%	17.3%	16.3%	15.7%
ROIC	18.0%	17.2%	16.3%	15.8%
Stability (%)				
Net debt to equity	99.2%	107.6%	115.5%	121.1%
Net debt/(net debt+equity)	49.8%	51.8%	53.6%	54.8%
Current ratio	0.62	0.57	0.58	0.57
Interest coverage (X)	11.0	9.4	8.8	8.4

Operating Statistics	2006	2007	2008E	2009E
Fixed Lines (m)	9.9	9.8	9.5	9.2
Blended Fixed ARPU ($/mth)	62.3	60.8	59.4	58.3
Aust Mobile Subs (m)	8.43	8.88	9.27	9.56
Blended Mobile ARPU ($/mth)	44.5	45.4	45.0	45.0
No. Employees	44,452	43,411	40,387	38,161

Balance Sheet	2006	2007	2008E	2009E
Cash/deposits	689	823	930	898
Accounts receivable	3,721	3,891	3,982	4,053
Inventory	224	332	332	332
Other current assets	265	307	307	307
Current assets	4,899	5,353	5,550	5,589
Fixed assets	23,592	24,607	25,045	25,346
Goodwill	2,073	2,126	2,126	2,126
Investment & other assets	5,660	5,789	6,280	6,434
Non-current assets	31,325	32,522	33,451	33,906
Total assets	36,224	37,875	39,001	39,495
Accounts payable	3,570	4,207	4,419	4,555
Short-term borrowings	1,982	2,743	2,743	2,743
Other current liabilities	2,347	2,484	2,484	2,484
Current liabilities	7,899	9,434	9,646	9,782
Long-term borrowings	11,442	11,619	12,619	13,119
Other LT liabilities	4,049	4,242	4,242	4,242
Non-current liabilities	15,491	15,861	16,861	17,361
Total Liabilities	23,390	25,295	26,507	27,143
Net Assets	12,834	12,580	12,494	12,352
Paid in capital	5,569	5,611	5,611	5,611
Reserves	(160)	(258)	(258)	(258)
Retained earnings	7,177	6,976	6,890	6,748
Minorities	246	251	251	251
Total shareholders' equity	12,832	12,580	12,494	12,352

Cash Flow	2006	2007	2008E	2009E
EBITDA	9,551	9,858	10,054	10,220
Tax paid	(1,882)	(1,618)	(1,456)	(1,432)
Interest paid	(933)	(1,087)	(1,171)	(1,237)
Other	926	367	121	65
Operating Cash Flow	7,662	7,520	7,549	7,616
Capital expenditure	(4,255)	(5,652)	(4,858)	(4,561)
Investments	(48)	(330)	(100)	(103)
Divestments	255	305	0	0
Free Cash Flow	3,614	1,843	2,591	2,952
Dividends paid	(4,970)	(3,479)	(3,484)	(3,484)
Debt increase/(reduction)	487	1,778	1,000	500
Equity Issued	0	0	0	0
Net Cash Flow	(869)	142	107	(32)

E = Morgan Stanley Research estimates
Source: Company data, Morgan Stanley Research

Investment Case

Summary & Conclusions

Telstra, as an integrated telco, continues to face various operational, transformation and regulatory uncertainties over the medium term. FTTN is a key issue that might not be resolved any time soon due to disagreements on access prices. Telstra has suggested a price of A$59/mth for a 512k connection, the G9 has proposed prices ranging from A$25-45/mth and the government is suggesting a price of A$35-60/mth for rural broadband (for OPEL JV).

We do not believe Telstra is likely to make this investment, unless the access prices are high enough to partially compensate for existing wholesale revenues and generate a *reasonable* return on the new investment. The economics of FTTN are reasonably weak, as (a) there is limited incremental ARPU; and (b) it will cannibalize its existing high margin fixed-line revenues.

- Based purely on ***incremental*** return analysis, we estimate the FTTN investment is unlikely to generate a positive return in the first three years of investment. Even then, the returns generated in the medium-term of 6-7% are below Telstra's WACC of 9.1%.
- On a ***standalone*** basis, we estimate that to generate a return of 14-16% on a A$4 billion FTTN investment, the average access price would need to be A$37-39/mth, including a A$10/mth charge from node-to-home. However, we estimate Telstra currently generates an average ARPU of A$84/mth from a wholesale DSL customer (voice and data), therefore a price of A$37-39 would result in a loss of A$45-47/mth ARPU.
- Alternative carriers (G9) also cannot make this investment without Telstra's co-operation, as issues like sub-loop unbundling, co-location and backhaul prices and terms are complex and costly, and require access to Telstra's networks.
- Another emerging risk is if ALP wins the next election and implements an 'open-access' broadband framework, we believe Telstra could lose up to A$600-900mn in annual revenues.

Our European team recently downgraded BT Group's (BT.L, 308.25p) rating to Underweight, with one of the key reasons being FTTN uncertainty – see *Fibre Risk Awakens: EPS Support Fade: Underweight*, for more details (20 Sept 2007). ULL migration is also accelerating – 90k in recent weeks, up from 50-60k previously. Telstra faces the same risks.

One possible way of overcoming this investment and operational uncertainty for Telstra, and to reduce the risk of further regulatory intervention, could be to *structurally* separate the Networks and Services business, in our view.

Similar to the analysis we undertook for TCNZ in May this year (see "*Unlocking Value through Structural Separation", dated May 21, 2007*) – we estimate this could result in around 20% upside to our base case Telstra valuation of A$3.94, or 10% upside to the current share price.

A vertical split of an integrated carrier like Telstra is unprecedented and a hugely complex exercise. A number of different structures are possible, with varying valuation outcomes. In our *simple* analysis, we have assumed that the hypothetical separation results in the creation of two separate entities – one focused on maintaining the access network businesses (Networks), and the other on selling services to consumers (Services). We have valued these businesses on an EV/EBITDA basis, along with Telstra's other businesses like mobiles, Sensis and Foxtel. This is summarized in Exhibit 2 below.

The company, the regulators and the government have not made any official comments in relation to this. However, we think that a change of government at the next election could be a catalyst for this debate to start. ***Telstra may itself review a separation scenario as a strategy to unlock/preserve value.*** We will monitor any such debate closely – and have not assumed this as our base case.

One of the main debates on Telstra is if the company can meet its 2010 targets for which the market remains divided. Telstra is holding another strategy day on November 1, where network transformation is likely to be a key focus. All these debates will become irrelevant and the long-term outlook will change if: (a) there is a FTTN decision beforehand; and/or; (b) if there is further intervention from the regulator/government, which could result in a structural separation of the company.

We have made no changes to our earnings forecasts, and maintain our Underweight call. In view of the current company structure, we do not believe the stock is cheap at 15.9x F2009e earnings. The risks in the near term remain high – especially with rising competitive pressures and possible delays in transformation benefits.

Exhibit 2

Telstra Hypothetical Break-Up Value

		EV/EBITDA Multiples			Enterprise Value (A$mn)		
	2009e EBITDA	Low	Base	High	Low	Base	High
Wireless	2,030	6.0	7.0	8.0	12,181	14,211	16,242
Directories	1,062	11.0	12.0	13.0	11,683	12,745	13,807
IT Services	166	5.0	5.5	6.0	831	914	997
CSL	318	5.5	6.0	6.5	1,750	1,910	2,069
TelstraClear	89	5.0	5.5	6.0	447	492	537
Other Offshore	39	5.0	5.5	6.0	195	215	235
IP & Data	583	6.0	7.0	8.0	3,497	4,080	4,662
Foxtel (Telstra's Share)	150	6.0	7.0	8.0	900	1,050	1,200
Other (Reach, etc)					200	300	400
Networks	2,755	7.5	8.5	9.5	**20,662**	**23,417**	**26,172**
Services	2,180	6.0	7.0	8.0	13,080	15,260	17,440
Total EV		**7.0**	**8.0**	**8.9**	**65,428**	**74,595**	**83,761**
Net Debt					14,905	14,905	14,905
Equity Value					50,523	59,690	68,857
Shares					12,443	12,443	12,443
Equity Value					**$4.06**	**$4.80**	**$5.53**

Source: Company data, Morgan Stanley Research. E = Morgan Stanley Research estimates

Why Is FTTN Return Dilutive?

FTTN is an ***incremental*** investment, for which Telstra needs to generate an ***incremental*** return to get a positive return. It is difficult to see what additional ARPUs could be generated via FTTN, which is currently not possible on copper. It is not obvious that customers would pay significantly more for broadband speeds over above those delivered by ADSL2+ services. In fact, services like IP-TV would only mitigate some of the revenue decline, and given the excess capacity generated by fibre networks, it could even accelerate the rate of decline in broadband prices.

In our view, the two main issues for FTTN are: (a) wholesale access prices; and (b) access terms. Both these issues are unlikely to be resolved any time soon. The problem is that the access price, which Telstra *needs* and *wants* to charge on FTTN, is not acceptable to the regulators. On the other hand, the competitive carriers (like the G9) cannot make this investment happen without Telstra's co-operation. We make the following points:

1. Based purely on ***incremental*** **return** analysis on FTTN, we estimate this investment is unlikely to generate a positive return in the first three years of investment.

2. On a ***standalone*** basis, we estimate that to generate a return of 14-16% on an A$4bn FTTN investment, the average access price would need to be A$37-39/mth, including an A$10/mth charge from node-to-home. However, we estimate Telstra currently generates an average ARPU of A$84/mth from a wholesale DSL customer (voice and data), therefore a price of A$37-39 would result in a loss of A$45-47/mth ARPU.

3. The G9 cannot make this investment happen without Telstra's co-operation. Issues like sub-loop unbundling, co-location and backhaul are complex and costly.

4. **Cost savings and market share outcomes alone can be viable reasons for this investment.** We estimate if Telstra generates A$200-300mn in annual cost savings, increases its annual retail broadband share by 3%, and slows down the rate of PSTN decline to 2-3% per annum, the breakeven price for FTTN is A$50-60/mth.

We review each of these points in more detail below.

1. FTTN Economics
The economics of Telstra's fibre-to-the-node (FTTN) as an ***incremental investment*** are relatively weak. We estimate this investment is unlikely to generate a positive return in the first three years of investment. Even then, the returns generated in the medium-term of 6-7% remain below Telstra's WACC of 9.1%. See Exhibit 4 for more details.

It is important to note that this analysis is based purely on ***incremental*** returns on FTTN – and not considering other benefits like market share loss outcomes or cost savings from FTTN.

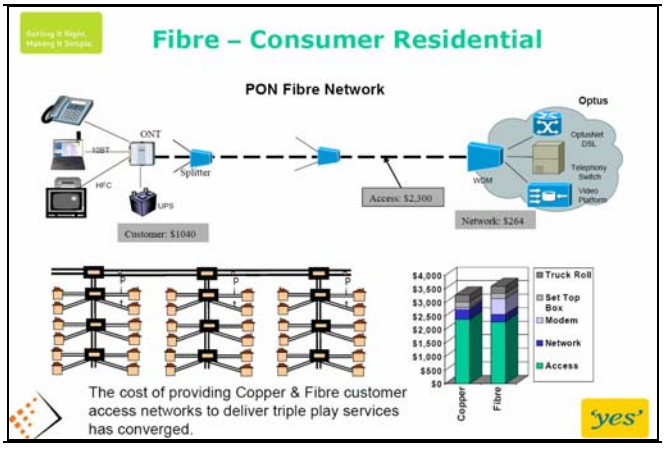
Key assumptions to note are:

- We assume capex per sub or A$1,000. Optus recently estimated that access capex per sub could be as high as A$2,500 for FTTH.

- Telstra increases its retail share to 60% from ~47% now.

- Incremental ARPU per **retail** sub of A$20/mth. We have not assumed any incremental ARPU per **wholesale** sub – as FTTN access charges will be a replacement of ULL charges, and are likely to be lower than the current wholesale ARPU of A$84/mth. However, if we do assume an additional A$10/mth in incremental wholesale ARPU, the FTTN investment becomes positive in year two.

Exhibit 3
FTTN Build Economics



Source: Optus Presentation – Australian Telecom Summit 2007

Exhibit 4

FTTN "Incremental" Return Analysis

	2008E	2009E	2010E	2011E	2012E	2013E	2014E	2015E
DSL Subscriber Base	4.1	4.7	5.3	5.8	6.2	6.6	6.9	7.3
% Metro	80	80	80	80	80	80	80	80
% Rural	20	20	20	20	20	20	20	20
Potential FTTN Subs			0.8	1.8	3.0	5.2	5.5	5.9
% FTTN			20	40	60	100	100	100
Australian Households	8.5	8.7	8.9	9.1	9.2	9.4	9.6	9.8
Homes Passed		1.74	2.66	3.62	4.62	4.71	4.80	4.90
% Homes with FTTN		20	30	40	50	50	50	50
Capex/Sub		1,000	1,000	1,000	1,000	1,000	1,000	1,000
Total Capex		1,741	923	959	996	92	94	96
Cumulative Capex			**2,663**	**3,622**	**4,618**	**4,711**	**4,805**	**4,901**
Subscriber Mix								
% Wholesale		40	40	40	40	40	40	40
% Retail		60	60	60	60	60	60	60
Wholesale FTTN Subs		-	0.3	0.7	1.2	2.1	2.2	2.3
Retail FTTN Subs		-	0.5	1.1	1.8	3.1	3.3	3.5
Total FTTN Subs		-	0.8	1.8	3.0	5.2	5.5	5.9
Incremental ARPUs								
Wholesale			0	0	0	0	0	0
Retail			20	20	20	20	20	20
Total revenues			122	194	349	593	777	821
EBITDA			73	116	209	356	466	493
% Margin			*60*	*60*	*60*	*60*	*60*	*60*
D&A			133	181	231	236	240	245
EBIT			(60)	(65)	(22)	120	226	248
Cumulative Investment			2,663	3,622	4,618	4,711	4,805	4,901
Cumulative Depreciation			133	314	545	781	1,021	1,266
Net Investment			2,530	3,308	4,073	3,930	3,784	3,635
Incremental Return (%)			**-2**	**-2**	**-1**	**3**	**6**	**7**

Source: Company data, Morgan Stanley Research, E = Morgan Stanley Estimates

2. FTTN Price – Wholesale DSL vs. ULL vs. FTTN
On a ***standalone*** basis (irrespective of who makes this investment), to generate a return of 14-16% (post-tax) on a A$4bn investment, we estimate an average access price of A$27-29/mth would be needed, and including a further A$10/mth node-to-home charge, the total average wholesale price would be A$37-39/mth.

We have used 5mn broadband subscribers in our calculations – which we estimate is the size of the total metro broadband market over the medium term.

This is similar to the prices proposed by G9 in their Special Access Undertaking in May 2007. Therefore, it appears that the G9's calculations are also based on a ***standalone*** investment.

However, this investment cannot be considered in isolation for Telstra. Telstra has legacy revenues to protect which will largely be replaced if FTTN investment is made.

We estimate Telstra currently generates an average ARPU of A$84/mth from a wholesale DSL customer (voice and data), therefore a price of A$37-39 would result in a loss of A$45-47/mth ARPU. Or, Telstra currently generates around A$2bn in wholesale revenues – therefore a price of A$37-39/mth would imply a loss of around 50% of these revenues. Moreover, Telstra would fail to generate a return on this investment.

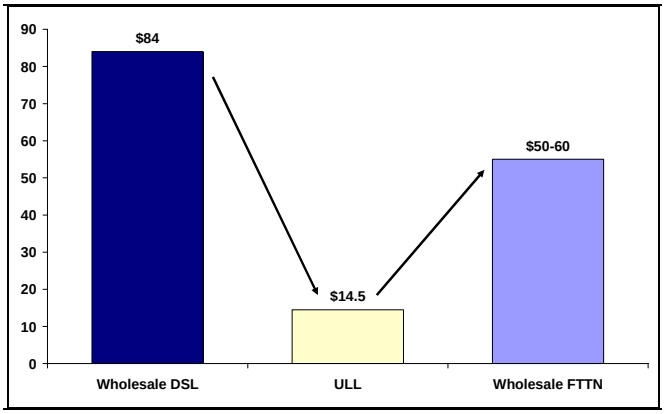
Without FTTN, ULL is a major risk for Telstra. As shown in Exhibit 6, moving from wholesale DSL to ULL, Telstra could potentially lose A$70 ARPU per subscriber per month. With FTTN, we estimate Telstra would need to charge an average access price of A$50-60/mth for it to be value neutral – and this could be a much better outcome than ULL.

Exhibit 5
G9 Proposed Prices

A$/mth	Access Charge	Total Charge
Basic Access	10.00	
Standard Broadband - 1.5Mbps	14.23	24.23
Standard Broadband - 6Mbps	18.46	28.46
Standard Broadband - 12Mbps	26.92	36.92
Standard Broadband - Unlimited	35.38	45.38

Source: FANOC, Special Access Undertaking, 30 May 2007

Exhibit 6
Wholesale Price Alternatives



Source: Company data, Morgan Stanley Research

Exhibit 7

FTTN: RoIC and Monthly Charge for "Standalone" Investment

A$mn		4,000	4,000	4,000	4,000	4,000	4,000	4,000	4,000	4,000
ROIC (%)		9	10	12	14	16	21	34	39	68
Annual return		360	400	480	560	640	840	1,360	1,560	2,720
Pre tax return	30%	514	571	686	800	914	1,200	1,943	2,229	3,886
Interest	7%	280	280	280	280	280	280	280	280	280
EBIT		794	851	966	1,080	1,194	1,480	2,223	2,509	4,166
D&A	20	200	200	200	200	200	200	200	200	200
EBITDA		994	1,051	1,166	1,280	1,394	1,680	2,423	2,709	4,366
Revenue	80%	1,243	1,314	1,457	1,600	1,743	2,100	3,029	3,386	5,457
Subs (mn)		*5.0*	*5.0*	*5.0*	*5.0*	*5.0*	*5.0*	*5.0*	*5.0*	*5.0*
Monthly FTTN Charge		$21	$22	$24	$27	$29	$35	$50	$56	$91
Node Charge		$10	$10	$10	$10	$10	$10	$10	$10	$10
Total Average FTTN Charge		**$31**	**$32**	**$34**	**$37**	**$39**	**$45**	**$60**	**$66**	**$101**

Source: Company data, Morgan Stanley Research

3. Issues for Alternative Carriers
We believe it is difficult for alternative carriers (other than Telstra) to make this investment happen without Telstra's involvement and co-operation.

As shown in Exhibit 7, the average access price of A$37-39/mth is based on a 5mn total subscriber base. ***If we were to exclude Telstra's market share of ~50%, then the average price rises to ~A$75/mth – which would result in higher retail prices – not the desired outcome.***

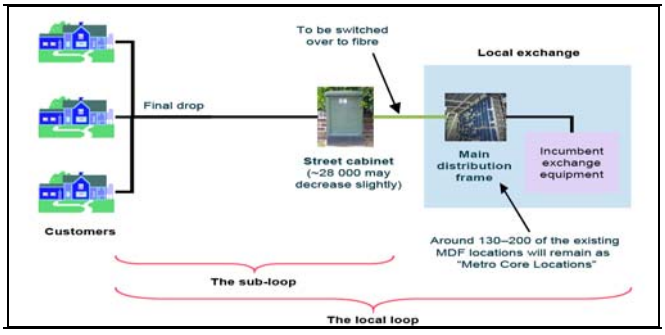
The G9 cannot make this investment without accessing Telstra's infrastructure. There are several other issues including sub-loop unbundling, co-location and backhaul – for which prices and access terms are important.

In a recent study on *sub-loop unbundling* in the Netherlands by Analysys Consulting for the Dutch market, it estimates that a business case for an access seeker with similar economic viability to that of continuing use of ULL for 60% of population would require both:

- a market share > 55% of all broadband lines (including cable); and
- a significant increase in ARPUs (incremental ARPU of €10/mth).

Therefore, the economics under sub-loop unbundling are difficult from an access seeker's perspective. The market size for an access seeker is much more limited under an FTTN model versus ULL. For example, under a ULL model, the potential market for an access seeker is the entire customer base around an exchange – whereas under an FTTN model, the potential market is reduced to 1-2 streets.

Exhibit 8
Sub Loop Unbundling Structure



Source: Analysys, January 2007

4. Cost Saving and Higher Market Share Potential
Although the economics of FTTN are relatively weak (based on incremental revenues), the potential for lower operating costs and the need to defend market share, can be two possible reasons for this investment.

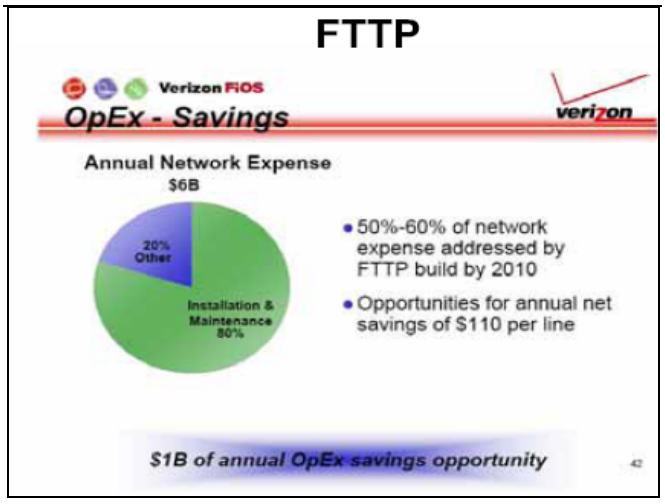
We estimate if Telstra generates A$200-300mn in annual cost savings, increases its annual retail broadband share by 3%, and slows down the rate of PSTN decline to 1-2% per annum, the breakeven price for FTTN is A$50-60/mth. As highlighted in Exhibit 11, we estimate:

- To maintain the current wholesale revenue of A$2bn, the average access price would need to be A$40-45/mth. This includes wholesale FTTN revenues, node-to-home charge of A$10/mth, some existing DSL lines, and ~A$200mn in additional revenues as a result of higher retail broadband share and slowdown in PSTN decline.
- If Telstra generates A$200-300mn in cost savings, it implies that for an average price of A$27-30/mth, this investment can be earnings breakeven. This price, although it would be earnings breakeven, means that this *incremental* investment has not generated an *incremental* return.
- Assuming a ROIC of 14% on a new investment is reasonable, and implies an average price of A$27/mth – as per Exhibit 7.
- **Therefore, for FTTN to be value breakeven, we estimate an average access price of between A$50-60/mth is required.**

The question remains if this price will be acceptable to Telstra or the regulators. **The average breakeven price could be lower if the cost saving potential is higher than our forecasts, or if Telstra wins more market share.**

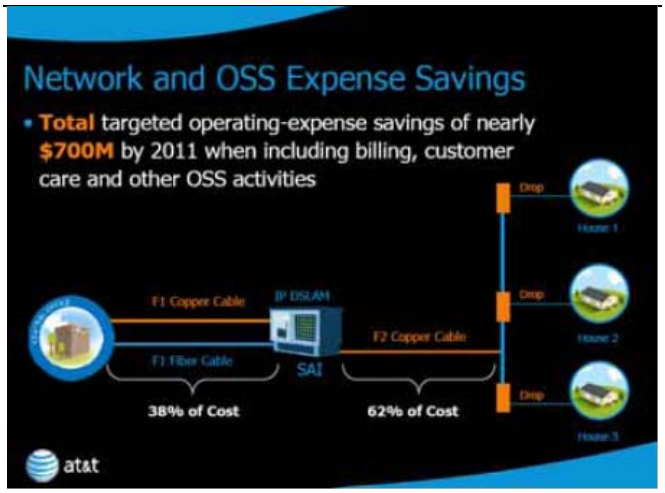
As highlighted in Exhibits 9-10, different carriers have varying estimates of cost savings from FTTN/FTTP. Verizon estimates FTTP can reduce network costs by 50-60%, while AT&T estimates 38% lower costs from FTTN. Most of these cost savings are driven by lower plant maintenance, installation and customer care costs, as DSLAMs are moved closer to the customer.

Exhibit 9
FTTP Cost Savings



Source: Verizon

Exhibit 10
FTTN Cost Savings



Source: AT&T

Exhibit 11
Revenue Impact from FTTN

FTTN Price	Wholesale FTTN Lines	Addition Node Charge	Wholesale DSL Lines	FTTN Benefit	Total Revenue	Net Impact
	2.2	*@ A$10/mth*	*0.5*	*2009e*		
$25.0	660	264	367	197	1,488	(401)
$27.5	726	264	367	197	1,554	(335)
$30.0	792	264	367	197	1,620	(269)
$32.5	858	264	367	197	1,686	(203)
$35.0	924	264	367	197	1,752	(137)
$37.5	990	264	367	197	1,818	(71)
$40.0	1,056	264	367	197	1,884	(5)
$42.5	1,122	264	367	197	1,950	61
$45.0	1,188	264	367	197	2,016	127
$47.5	1,254	264	367	197	2,082	193
$50.0	1,320	264	367	197	2,148	259
$52.5	1,386	264	367	197	2,214	325
$55.0	1,452	264	367	197	2,280	391
$57.5	1,518	264	367	197	2,346	457
$60.0	1,584	264	367	197	2,412	523
$62.5	1,650	264	367	197	2,478	589
$65.0	1,716	264	367	197	2,544	655
$67.5	1,782	264	367	197	2,610	721
$70.0	1,848	264	367	197	2,676	787

Source: Company data, Morgan Stanley Research

Overcoming FTTN Uncertainty… A Possible Break-up?

As highlighted in the previous section, we do not believe FTTN investment will happen in the current structure, which may be more feasible under a structurally separated Networks business.

We acknowledge there is no political will at this point to review this scenario – however a change in government (or even if the current government is re-elected), could be a catalyst to revisit this debate. Telstra may itself review a separation scenario as a strategy to unlock/preserve value. ***We will monitor any such debate closely – and have not assumed this as our base case.***

Globally, structural separation is one of the emerging debates, as incumbent carriers are finding it difficult to justify incremental investment in networks without destroying overall returns, and as a possible way of unlocking some value.

- The key argument in ***favor*** of it is that it removes behavioral obstacles to competition, resulting in more competition, investment and innovation.

- The key argument ***against*** it is that it could possibly result in reduced infrastructure based competition, and requires high implementation costs.

A separation of Telstra was considered back in 2003; however, it was short-lived, due to the expected implementation costs, and was considered to destroy shareholder value. The Minister at the time decided to implement '**accounting separation**' instead, and relied on the Trade Practices Act (Part XIC and XIB) to address competition issues in the country. There were also concerns at the time that the incumbent telecoms are so integrated that it is impractical to separate Telstra's network and services businesses.

Most of the submissions lodged by various industry participants at the time conceptually agreed with the merits of a separation, but recommended against it due to the practical challenges associated with implementing such reforms.

Telstra at the time estimated total separation costs of up to A$2bn with on-going costs of A$80mn per annum. This was based on previous estimates made by Verizon in the US. Evidence since then has been that operational costs are much lower – BT's total operational separation costs in 2006 were £70mn (A$175mn), and TCNZ estimates its operational separation costs could range around NZ$200-500mn. There is not likely to be too much difference between operational and structural separation costs. Also, there is an argument that with the transformation of networks to IP platforms, separation should be relatively easier and cheaper.

What was Telstra's View in 2003?
Telstra in its submission in 2003 (Parliamentary Inquiry into Structural Separation, Submission No 59), strongly recommended ***against*** structural separation and concluded, *"It would lead to a reduction in national efficiency, an increase in telecommunications costs and to higher prices for consumers. Breaking up the Telstra business and network would eliminate the economic efficiency benefits that come from operational integration. Creating an artificial boundary line between what Telstra could and could not do would inevitably be arbitrary and the long-term effects damaging.*

Its four conclusions were:

1. *Any break-up of the network would be arbitrary and impose significant structural rigidities, which would hamper innovation and technological improvements.*

2. *Structural separation would impose significant costs on Australian consumers.*

3. *Structural separation will reduce the operating efficiencies that are currently used to help fund uneconomic services, particularly in rural and remote Australia.*

4. *Structural separation will send strong negative signals to investors, especially international investors, as such a dramatic policy intervention increases sovereign risk and runs against the trend of regulation elsewhere around the world.*

Of the above, we agree with (3). As shown in the previous section, in the current structure it is perhaps even more difficult for Telstra to make investments that would address *technological improvements*, unless the access prices are very high – which is not likely.

FTTN is one reason…
Telstra, its competitors, regulators and the government have not been able to reach a decision on FTTN, and the issue is not likely to be resolved any time soon, in our view. At the same time, operational risks for Telstra appear to be rising from ULL.

FTTN economics do not stack up for Telstra unless the access prices are very high, which the ACCC/coalition/ALP is not going to allow. It is an *incremental* investment with limited scope for *incremental* returns. In the current structure, (a) it is difficult to see this investment happening any time soon; and (b) it is difficult to see it being value accretive for Telstra. One of the main reasons why Telstra would want to make this investment is to reduce the risk of ULL, we believe.

At the last result, there were early signs of the ULL threat becoming more transparent. Telstra reported a 100% increase in ULL SIOs to 239k, which only added A$8mn in additional ULL revenues. This reflected lower access prices during the year and significant revenue dilution from moving from wholesale to ULL. Domestic wholesale access lines dropped 180k – of which ULL represented 2/3rd of the decline. With FTTN outcome delayed until mid-next year, and ULL prices coming down further, we expect the rate of wholesale access line decline to accelerate, especially now with Optus also focusing on expanding its on-net subscribers.

As stated earlier, FTTN is even more difficult for the other carriers (like G9). Issues like sub-loop unbundling, co-location at the node, backhaul, etc. are complex, costly, and require Telstra's co-operation. More importantly, for access seekers, the market size around a node is much smaller than around an exchange via ULL, therefore pricing and access terms are far more important under FTTN.

Our European team recently downgraded BT Group's rating to Underweight, with one of the key reasons being FTTN uncertainty, which will negatively impact cash flows (see "*Fibre Risk Awakens: EPS Supports Fade: Underweight", dated September 20, 2007*, for more details).

The ULL migration rate in the UK is also accelerating – 90k in recent weeks, up from 50-60k previously. Telstra faces the same risks.

Although the team believes that an FTTN rollout could be years away for BT, the key driver is likely to be rising competition issues. The three reasons highlighted are:

1. **ADSL2+ won't improve speeds for all** - Analysis from the Broadband Stakeholder Group suggests that ADSL2+ with speeds of 10Mbps and above is only likely to be available to around 30% of households and that currently true 8Mb speeds are only available to 20% of households.

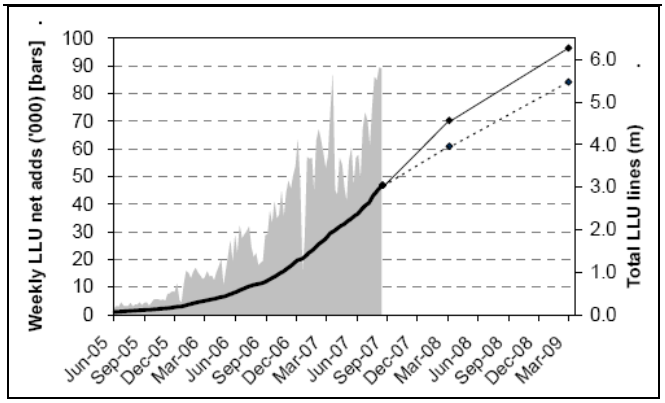
2. **Competitive forces are at work**: Mobile broadband, via increased sales of datacards, HSPA network upgrades, and mobile network refarming, will continue to force fixed networks to maintain a 'bandwidth advantage' over the longer term.

3. **UK behind on fibre despite being ahead on broadband penetration.** An increasing number of European countries have already begun fibre investment.

Once again, the economics are reasonably weak, and it is not clear if the regulator will provide some incentives. Recent comments from Ed Richards (new head of Ofcom) at the US congressional sub-committee on fibre investment in April 2007 suggest regulatory incentivisation in this regard is not necessary:

"… We have looked at going much further and introducing policies of regulatory forbearance. Some incumbents in Europe, though not BT, have called for 'regulatory holidays' for NGN investments — essentially the removal of all pro-competition rules. We do not agree that this is necessary to secure NGN investments, and we think the price of such a policy in a UK context would be extremely high. We would be sacrificing competition in return for an investment that BT can and will make in any event."

Exhibit 12
BT's ULL Weekly Net Additions



Source: Company data, Morgan Stanley Research

ALP's Open-Access Is Another…
As we have seen in regional/rural areas, government subsidies are one way of encouraging these investments while keeping a lid on access prices. Perhaps government subsidies are also what are required in metro areas to see this investment happen. Or, as the ALP is proposing, an "*open access*" public/private structure for FTTN investment. This makes sense for consumers, competitors, regulators, but not for Telstra, in our view.

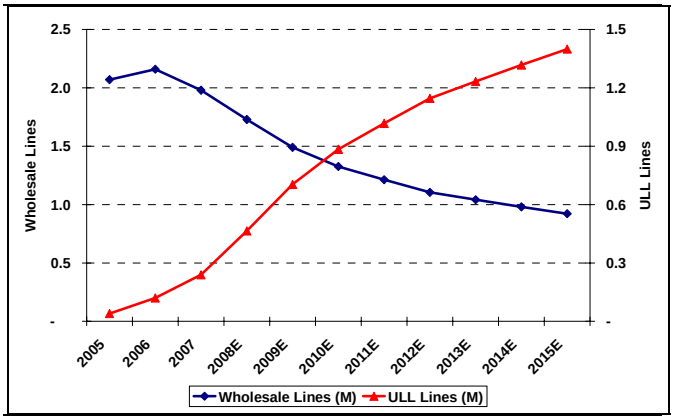
We estimate Telstra could lose up to A$600-900mn in revenues in an '*open-access*' broadband framework.

- There are currently 2mn wholesale subscribers generating total ARPU (voice + data) of A$84/mth, of which we estimate 50% could be at risk (based on current retail shares) → *A$1bn revenue at risk*;
- Telstra generates A$6.3bn in PSTN and retail broadband revenues, which could come under pricing pressure, and we estimate these could be impacted by 5-10% → *loss of A$300-600mn in revenues*;
- This is offset by a A$10/mth node-to-home charge for wholesale subs → *benefit of A$120mn*;
- In a public-private partnership structure (as proposed), assuming the government will have approximately 50% share, and for the rest of the market, Telstra maintains its 50% retail broadband share (at A$40/mth average FTTN charge) → *benefit of A$600mn*;
- Net impact: A$600-900mn revenue loss.

Telstra *can* and *has* the capacity to make this investment on its own without any subsidies; however, the problem is that the pricing it *needs* and *wants* to charge to get an economical return would result in higher consumer prices – not the outcome desired by the regulators. This is a dilemma for Telstra, as without this investment, ULL risks become more real.

In our view, a structural break-up could be the answer. This would allow the company to separate its Network business into a different entity that could charge regulated access prices to all carriers, including Telstra. This is similar to the regulated access prices that BT's Openreach is allowed to charge.

Exhibit 13
Telstra ULL vs. Wholesale SIOs



E = Morgan Stanley Research estimates
Source: Company data, Morgan Stanley Research

Exhibit 14
Potential Revenue Impact with ALP's *Open-Access*

	Open Access Impact	
Wholesale Subs (mn)		2.00
ARPU (A$/mth)		84.00
Wholesale Revenues (A$mn)		2,096
% Subs at Risk (mn)		1.00
Potential Wholesale Revenue at Risk (A$mn)		1,008
Retail PSTN + Broadband Revenue		6,283
Pricing Pressure Impact	***5%***	***10%***
Retail Revenues at Risk (A$mn)	314	628
Total Gross Revenue at Risk (A$mn)	1,322	1,636
Incoming Revenues		
Node-to-Home Revenue @ $10/mth	120	120
Revenue Share of Public-Private Structure	600	600
Total Incoming Revenues (A$mn)	**720**	**720**
Net Revenues at Risk (A$mn)	**602**	**916**

Source: Company data, Morgan Stanley Research

Even the Current Government Could Re-Think…
The relationship between Telstra and the current government is not at its best. The government wants to see further network investments at a *reasonable* price, and both parties have different views on what is *reasonable*. The government has commissioned an Expert Taskforce to review the FTTN proposals, and has explicitly stated that the Taskforce is to have particular regard to:

i) the government's strong commitment to **robust competition** and the **long-term interests of end-users**;

ii) the commitment that all people in Australia have access to quality telecommunications services **at affordable prices**; and

iii) the need for **investors to earn returns on their investment commensurate with the cost of their investment** and their risks.

The government has also asked for consideration of access price and non-price terms; potential for compensation for stranded DSLAM investments; sub-loop unbundling price; rural subsidies; and risks of duplicate networks. These are extensive and complicated issues, which will require significant input from all participants.

In the recent OPEL decision, the Minister (Senator Helen Coonan) stated that retail prices in regional/ rural areas will range from A$35 to A$60/mth for a 12Mb connection. This compares to Telstra's proposal of 512k connection for A$59/mth of FTTN. Therefore, it will be difficult to envisage an access pricing decision that will satisfy all parties.

Also in the subsequent release, the Minister stated that "*OPEL is a* **structurally separated 'wholesale only' company***, that will operate and maintain the network, and that will sell services on a transparent and equivalent basis to parent entities, Elders and Optus, and to any other broadband provider in the market."*

Perhaps, it is possible that the government may consider alternative measures like a structural separation in metro areas too.

A break-up of Telstra appears to be gaining industry support. At a recent industry conference (Australian Information Industry Association) in Sydney recently, a number of smaller carriers (Primus, Macquarie) and the ACCC suggested that there is a need for industry reform, and ALP (if it wins the next election) could be best placed to do it.

In our view, the ***advantages*** of a break-up for Telstra could be:

- The Network business could achieve more certainty on regulations and investments, and could be rated as a regulated utility given its stable cash flows;
- Similarly, the Service business could be perceived as a growth business – with a better growth profile than Telstra as a whole entity;
- Separation could result in more efficient capital allocation based on the levels of risks; and
- It could remove regulations in the Services business.

The ***disadvantages***, however, could be:

- Separation could see more retail competition but reduce infrastructure-based competition – there are inherent synergy benefits between networks and service provision, which encourage access seekers to make more investments.
- It will be a costly and time-consuming exercise. BT estimates Netco separation costs of £70mn (A$175mn), and TCNZ estimates its operational separation could range from NZ$200-500mn. A separated network would require its own management, location, systems, etc.
- It could result in a loss of efficiency and may result in higher prices.
- There is a risk that the rate of return may not be sufficient to encourage further investment.

We acknowledge that a break-up of an integrated telco like Telstra is a very complicated exercise, and the valuation outcome will depend on the specifics of the model. There are a number of issues that need to be considered – such as the transfer pricing regime, regulated returns, asset allocations, USO (Universal Service Obligation) obligations, and whether the Networks and Services businesses can compete in each other's markets.

What are the different Structural Separation Options?
The Allen Consulting Group in its study in December 2006, "*Structural Separation of Telstra – why is it needed, and what can be done"*, proposed the following options (Exhibit 15):

(a) Vertically splitting the wholesale and retail fixed-line elements, namely the copper access network, from the retail fixed-line business;

(b) Selling the HFC network to create infrastructure-based competition;

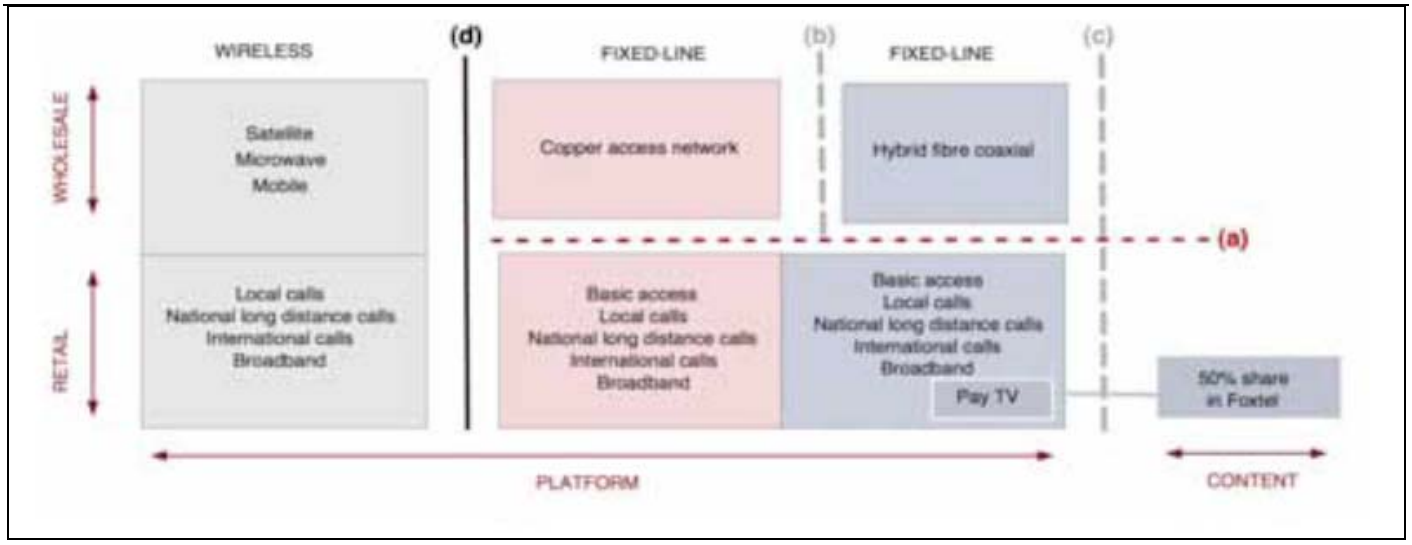
(c) Divesting Foxtel ownership;

(d) Separating Telstra's mobile business from the rest of its businesses.

We believe any of the (a), (b), or (c) is possible – but in our analysis, we have only considered (a). Option (d) appears less likely given the existing mobile competition.

One of the key issues in such a scenario is likely to be what assets are included in the Network separation. Based on the proposals submitted by TCNZ and BT, they offered to include all "fixed-line local access bottleneck assets", which will enable it to deliver equivalence between access seekers and promote competition in downstream services. These were cable, local access and regional backhaul fibre, civil infrastructure and buildings, cabinets and transport electronics, connection points such as MDFs, and du-port facilities. It did not include any assets that service providers can build themselves – such as DSLAMs and mobile assets.

Exhibit 15
Structural Separation Options



Source: The Allen Consulting Group, December 2006, "Structural Separation of Telstra – why is it needed, and what can be done"

Emerging International Trends
BT in the UK has established Openreach,while Eircom in Ireland and TCNZ in New Zealand are reviewing the possibility of structural break-up, along with a number of other European carriers. The incumbent telcos are finding it difficult to justify new investments like Fibre, as incremental returns on these are limited, and these investments are margin dilutive to the overall business. Another reason is to reduce regulatory intervention.

There are limited case-studies of a full *vertical* separation. Most of the separation that has occurred (AT&T, etc.) is more along the infrastructure lines.

Feedback from BT
BT's Head of Global Interconnection/Regulation, Grant Forsyth, made the following comments in an industry newsletter (La Lettre, March/April 2007 edition):

"The benefits of functional separation:

- *BT, Ofcom, competitors and consumers all benefit from the undertakings. First of all, BT benefits from retaining the efficiencies of a vertically-integrated operator and removing the uncertainty of future harsh regulatory remedial actions, thereby allowing it the ability to invest and innovate with greater freedom.*

- *Without this assurance, BT would undoubtedly have been more reluctant to invest in its 21C next generation network.*

- *Ofcom benefits through having a clearer regulatory focus on the incumbent telecommunications operator, which is now subject to strict oversight of its compliance with nondiscrimination principles.*

- *Furthermore, competitors can have greater confidence in the industry through a level playing field which will result in increased investment and innovation leading to greater choice and lower prices to the benefit of all consumers.*

- *And last but not least, investor confidence has not been dampened. The creation of Openreach and its own separate reports provides a clearer picture of the financial performance of different parts of the business. The increased transparency is likely to lead to BT having greater analyst coverage and greater access to capital funding in the financial markets. Helping to create a climate of confidence for sustainable infrastructure competition, investment and innovation, BT has shown a relatively strong share performance compared with many of its European peers since it announced its undertaking to functionally separate."*

In addition, Ed Richards, CEO, OFCOM, made the following comments in the same newsletter:

How is the policy working in practice? So far, very well. Openreach went from a theory to a practical reality in six months. Its creation has prompted a new wave of investment in the UK telecoms market which in turn has triggered a major price war in the broadband market.

- *Importantly, there have been big benefits for BT itself – we have been able to deregulate retail markets and BT's share price has risen partly because of confidence that there is a new stability in the relationship with the regulator.*

- *Ironically, some European incumbents who were initially very hostile to functional separation are now seriously examining it for this reason.*

How relevant is this UK experiment to other regulators? We certainly don't believe that all regulators would need to follow the UK approach to achieve effective competition – this depends on national market circumstances. The degree of 'Functional Separation required in different national markets would also differ. But we do believe that all regulators should have the powers to impose functional separation under the EU Framework even if only as a power of last resort.

Hypothetical Break-up Value

A vertical split of an integrated carrier like Telstra would be unprecedented and a hugely complex exercise. A number of different structures are possible, with varying valuation outcomes.

Similar to the analysis we undertook for TCNZ in May this year (*Unlocking Value through Structural Separation*) – we estimate under a hypothetical break-up scenario that Telstra shares could be worth A$4.80 per share with a range of A$4.06 to A$5.53 per share.

The key variables in this valuation are:

(a) What is the Network business worth?

(b) What is the Service business worth once the Network business is separated?

(c) What is the value of the rest of the businesses?

This is summarized in Exhibit 17 below, and we discuss each of these in more detail below.

We again stress that the valuation outcome will depend on the structure chosen for separation (vertical or horizontal), which assets are included, and other commercial arrangements. These can substantially influence the magnitude of shareholder value created/destroyed under a separation model.

For the purpose of this hypothetical exercise, we have assumed a high-level break-up of the Network (local loop or copper network) and Service businesses. We have not assumed any divestments or a change in the capital structure.

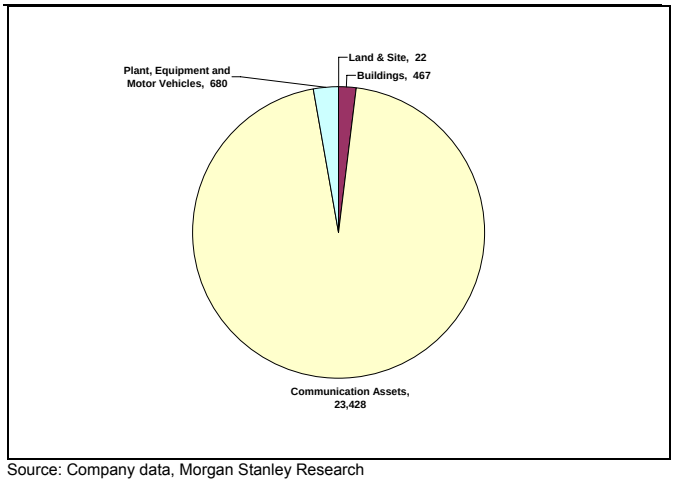
(a) Network Value
Our base-case valuation of the network business of A$23.4bn is based on the following assumptions:

- Replacement value per line of A$2,000;
- Regulated pre-tax WACC of 10%;
- 20-year depreciation schedule;
- EV/EBITDA of 8.5x.

The value of Network is perhaps the most complicated part of this valuation exercise. These are depreciated assets, where the book value is not reflective of the current asset value or the replacement value. For example, total PPE as at June 2007 was A$24.6bn. However, this includes Telstra's mobile assets, copper, cable, other infrastructure, etc.

Therefore, to value Telstra's fixed-line copper networks, we (a) estimate the replacement value per line; (b) apply a regulated rate of return to determine its annual EBITDA contribution; and (c) then apply a utility type multiple to work out the market value of these networks.

Exhibit 16
Telstra's PPE (June 2007) A$mn



Source: Company data, Morgan Stanley Research

Exhibit 17

Telstra Hypothetical Break-Up Value

		EV/EBITDA Multiple			Enterprise Value (A$mn)		
	2009e EBITDA	Low	Base	High	Low	Base	High
Wireless	2,030	6.0	7.0	8.0	12,181	14,211	16,242
Directories	1,062	11.0	12.0	13.0	11,683	12,745	13,807
IT Services	166	5.0	5.5	6.0	831	914	997
CSL	318	5.5	6.0	6.5	1,750	1,910	2,069
TelstraClear	89	5.0	5.5	6.0	447	492	537
Other Offshore	39	5.0	5.5	6.0	195	215	235
IP & Data	583	6.0	7.0	8.0	3,497	4,080	4,662
Foxtel (Telstra's Share)	150	6.0	7.0	8.0	900	1,050	1,200
Other (Reach, etc)					200	300	400
Networks	2,755	7.5	8.5	9.5	**20,662**	**23,417**	**26,172**
Services	2,180	6.0	7.0	8.0	13,080	15,260	17,440
Total EV		**7.0**	**8.0**	**8.9**	**65,428**	**74,595**	**83,761**
Net Debt					14,905	14,905	14,905
Equity Value					50,523	59,690	68,857
Shares					12,443	12,443	12,443
Equity Value					**$4.06**	**$4.80**	**$5.53**

Source: Company data, Morgan Stanley Research. e = Morgan Stanley Research estimates

Exhibit 18

Hypothetical Earnings Impact on Services Business (F2009e)

	Pre Network Separation			Post Network Separation		
	Revenues	EBITDA Margin	EBITDA	Revenues	EBITDA Margin	EBITDA
Wireless	5,801	35%	2,030	5,801	35%	2,030
Directories	2,124	50%	1,062	2,124	50%	1,062
IT Services	1,108	15%	166	1,108	15%	166
CSL	1,061	30%	318	1,061	30%	318
TelstraClear	596	15%	89	596	15%	89
Other Offshore	391	10%	39	391	10%	39
IP & Data	1,943	30%	583	1,943	30%	583
Foxtel (Telstra's Share)	750	20%	150	750	20%	150
Networks				5,510	50%	2,755
Services	10,960	53%	5,849	5,450	40%	2,180
Total	**24,734**	**42%**	**10,288**	**24,734**	**38%**	**9,373**
Earnings Impact (%)						-9

Source: Company data, Morgan Stanley Research. e = Morgan Stanley Research estimates

What is the Replacement Value?
We have used the "replacement value" concept to determine the Regulated Asset Base (RAB) – using BT's multiples as a starting point. For BT, the RAB is £11bn, which is based on current cost accounting. Based on the total WLR, ULL and retail lines of ~25mn, the cost is approximately £450 per line, or A$1,200 per line. However, given Australia's land-size, this could potentially range from A$1,000 to A$2,500 per line.

Based on these estimates, we value Telstra's existing copper network at between A$9.2bn and A$22.9bn, ***with a base case valuation of A$18.4bn using an average price of A$2,000 per line***. An important point to note is if the whole existing network were to be replaced, the technology of choice would now be fibre-to-the-home (FTTH), not copper, for which the replacement costs could be as high as A$40-50bn. This is based on our estimates that the cost of FTTH rollout is around A$4,000-5,000 per line.

It is important to note that the RAB is different to the market value of these assets. *In utility businesses, RAB is the capital value of the assets used by regulators in setting prices or price limits for utility companies.* Utilities tend to trade at a substantial premium to its RAB (20-70%) due to their stable predictable returns, and higher gearing potential. To work out the market value of Networks, we need to determine what the regulated WACC is.

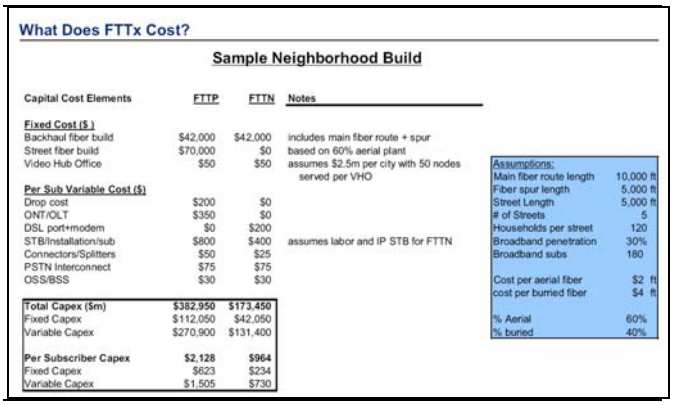
Regulated WACC?
The objective for the regulator is to set the 'regulated return' which would imply that the enterprise value of the asset is close to or equal to the RAB. If the regulated return is below Telstra's average cost of capital, then it would not be able to attract additional investment. On the other hand, if the return is too high, then prices will be too high, which will result in lower usage.

In Exhibit 21, we highlight regulated returns for various utilities in Australia and New Zealand. The average pre-tax WACC is 9%. For telecommunications, it could be argued that the return should be higher to account for various technology risks.

In BT's case, the regulator has agreed to a 10.1% pre tax WACC on Openreach – which is 270bps higher than BT's WACC of 7.4%.

Using a similar rate of 10% pre-tax WACC for Telstra's Network business, and a 20-year depreciation schedule, we estimate the regulated return or annual EBITDA would be A$2.76bn.

Exhibit 19
FTTN versus FTTH Estimates (US$)



What Does FTTx Cost?

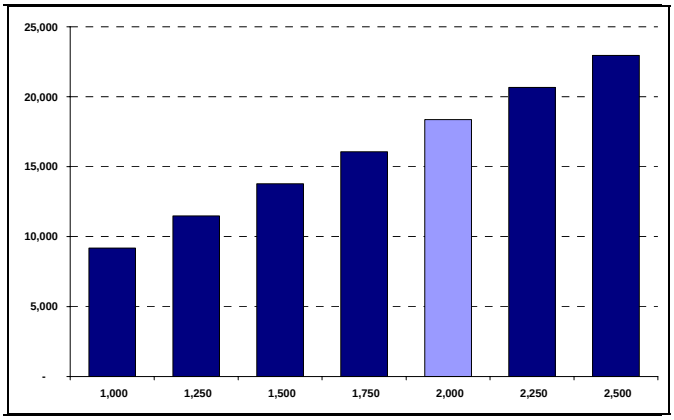
Sample Neighborhood Build

Capital Cost Elements	FTTP	FTTN	Notes
Fixed Cost ($)			
Backhaul fiber build	$42,000	$42,000	includes main fiber route + spur
Street fiber build	$70,000	$0	based on 60% aerial plant
Video Hub Office	$50	$50	assumes $2.5m per city with 50 nodes served per VHO
Per Sub Variable Cost ($)			
Drop cost	$200	$0	
ONT/OLT	$350	$0	
DSL port+modem	$0	$200	
STB/Installation/sub	$800	$400	assumes labor and IP STB for FTTN
Connectors/Splitters	$50	$25	
PSTN Interconnect	$75	$75	
OSS/BSS	$30	$30	
Total Capex ($m)	$382,950	$173,450	
Fixed Capex	$112,050	$42,050	
Variable Capex	$270,900	$131,400	
Per Subscriber Capex	$2,128	$964	
Fixed Capex	$623	$234	
Variable Capex	$1,505	$730	

Assumptions:	
Main fiber route length	10,000 ft
Fiber spur length	5,000 ft
Street Length	5,000 ft
# of Streets	5
Households per street	120
Broadband penetration	30%
Broadband subs	180
Cost per aerial fiber	$2 /ft
cost per buried fiber	$4 /ft
% Aerial	60%
% buried	40%

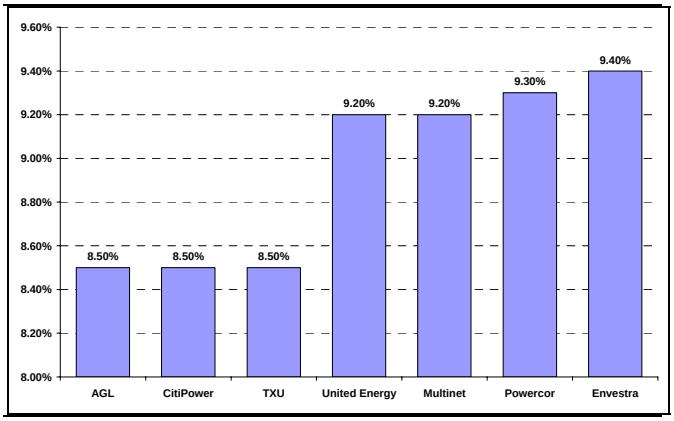
Source: Morgan Stanley Research; *Global Telecom Outlook Day 2006*

Exhibit 20
Replace Value at Different Prices (A$bn)



Source: Company data, Morgan Stanley Research

Exhibit 21
Pre-tax WACC of Utilities



Source: Company data, Morgan Stanley Research

Market Value of Networks?
Applying an 8.5x EV/EBITDA multiple, we estimate the market value of Networks to be A$23.4bn. This represents a ~30% premium to Regulated Asset Base (RAB). The question is if 8.5x is the right multiple.

Our UK team values Openreach at 6.8x EV/EBITDA. If we were to use the same multiple for Telstra's Network – our hypothetical base case valuation reduces to A$4.40.

There is no guarantee that the Network business can meet its regulated returns. For example, in the recently published regulatory accounts, Openreach achieved a pre-tax return of 9.7% in 2007, which has implications for the premium that can be applied to RAB. Our European team recently reduced their premium to RAB for Openreach to 0% (~20-30% previously) mainly due to competition concerns (migration to mobile datacards)

For Telstra, we make the following points:

- Regulated WACC for Telstra could be higher given the higher risk-free rate in Australia;
- Telstra's current WACC of 9.1% is higher than BT's 7.4%;
- Relative to BT, competition is arguably more benign, and Telstra is more integrated to manage competitive risks.

Given limited comparables in the telecommunications sector, we also use valuation multiples for Australian utilities. Based on IBES data, the average EV/EBITDA for Australian utilities is 12.3x, with a range of 7-16x. Telstra's copper business has utility type characteristics – irreplaceable utility-like local loop infrastructure, stable predictable returns, and potential for high gearing.

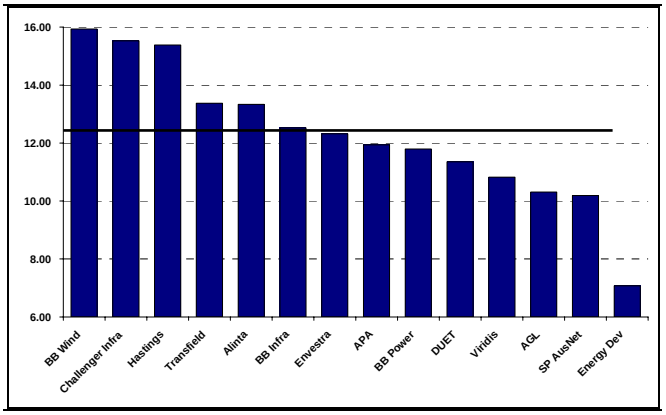
Using a range of replacement value of A$1,000 to A$2,500 per line, and applying an EV/EBITDA multiple of 7.5-10.5x, we derive a hypothetical break-up valuation range of A$4.37 to A$5.51 per share (this assumes our current base-case values for all other businesses).

Exhibit 22
Market Value of Networks

Access Lines	9.2 million
Replacement Cost	2,000
Replacement Value	18,366
Pre-tax WACC (%)	10
EBIT	1,837
Dep (5%)	804
EBITDA	2,640
At 7.5x	20,662
At 8.5x	**23,417**
At 9.5x	26,172

Source: Company data, Morgan Stanley Research

Exhibit 23
Australian Utility 2008e EV/EBITDA



Source: I/B/E/S estimates

Exhibit 24
BT's Regulatory Reporting Summary

in GBP m	F06	F07	F07	F07
Access Markets Mean Capital Employed (includes some parts of BT Wholesale)	11,012	11,186		
		Total Openreach	**o/w copper**	**o/w non-regulated**
Openreach Total Capital Employed	n/a	12,311	9,550	2,761
Pre-tax return post adjustments	1094	1,194	878	316
pre-tax RoIC (%)	9.9	9.7	9.2	11.4
Implied post tax @ 30%	7.0	6.8	6.4	8.0

Source: BT Plc.

Exhibit 25

Hypothetical Valuation Scenarios at Different Replacement Prices and EV/EBITDA Multiples

	EV/EBITDA Multiple						
	7.5	8.0	8.5	9.0	9.5	10.0	10.5
At A$1,000 replacement value	$4.37	$4.42	$4.48	$4.53	$4.59	$4.64	$4.70
At A$1,500 replacement value	$4.47	$4.55	$4.64	$4.72	$4.80	$4.89	$4.97
At A$2,000 replacement value	$4.58	$4.69	**$4.80**	$4.91	$5.02	$5.13	$5.24
At A$2,500 replacement value	$4.68	$4.82	$4.96	$5.10	$5.23	$5.37	$5.51

Source: Morgan Stanley Research

Exhibit 26

Hypothetical Valuation Scenarios of Telstra's Network

2009 Access Lines	9.18	9.18	9.18	9.18	9.18	9.18	9.18
Replacement Value	1,000	1,250	1,500	1,750	2,000	2,250	2,500
Copper Replacement Value	***9,183***	***11,479***	***13,775***	***16,071***	***18,366***	***20,662***	***22,958***
Pre-Tax WACC							
9.00%	*826*	*1,033*	*1,240*	*1,446*	*1,653*	*1,860*	*2,066*
10.00%	***918***	***1,148***	***1,377***	***1,607***	***1,837***	***2,066***	***2,296***
11.00%	*1,010*	*1,263*	*1,515*	*1,768*	*2,020*	*2,273*	*2,525*
12.00%	*1,102*	*1,377*	*1,653*	*1,928*	*2,204*	*2,479*	*2,755*
Depreciation Rate							
5%	459	574	689	804	918	1,033	1,148
EBITDA							
9.00%	1,286	1,607	1,928	2,250	2,571	2,893	3,214
10.00%	**1,377**	**1,722**	**2,066**	**2,411**	**2,755**	**3,099**	**3,444**
11.00%	1,469	1,837	2,204	2,571	2,939	3,306	3,673
12.00%	1,561	1,951	2,342	2,732	3,122	3,513	3,903
Market Value of Networks at Different Multiples							
6.0	8,265	10,331	12,397	14,464	16,530	18,596	20,662
7.0	9,642	12,053	14,464	16,874	19,285	21,695	24,106
8.0	11,020	13,775	16,530	19,285	22,040	24,795	27,550
8.5	**11,709**	**14,636**	**17,563**	**20,490**	**23,417**	**26,344**	**29,271**
9.0	12,397	15,497	18,596	21,695	24,795	27,894	30,993
10.0	13,775	17,218	20,662	24,106	27,550	30,993	34,437
11.0	15,152	18,940	22,728	26,516	30,305	34,093	37,881
12.0	16,530	20,662	24,795	28,927	33,059	37,192	41,324
13.0	17,907	22,384	26,861	31,338	35,814	40,291	44,768
14.0	19,285	24,106	28,927	33,748	38,569	43,391	48,212
15.0	20,662	25,828	30,993	36,159	41,324	46,490	51,655

Source: Morgan Stanley Research

Exhibit 28 is a summary from our utilities and infrastructure team, who highlight the difference between the regulatory decisions on returns and premiums to WACC versus what is generally valued by the market. Three observations to make:

1) Gearing used by the regulator is around 60%, which is significantly lower than what is assumed by the market;

2) Pre-tax WACC is around 1.85 ppt lower; and

3) The premium to RAB of 1.50x as valued by the market is higher than a typical regulatory decision of ~1.40x. The reason for this is: (a) the market appetite for these type of vehicles is higher due to an attractive yield, (b) the regulator tends to overcompensate due to its desire to encourage investment.

The average EV/EBITDA multiple for utilities is 12.3x in Australia in 2008 (based on IBES estimates), and they trade at a 30-70% premium to their RAB.

Exhibit 27

Estimates of Pre-Tax WACC for BT's Openreach

	High Gearing	Low Gearing
Risk-free rate (%)	**4.7**	4.7
ERP (%)	4.5	4.5
Equity beta	0.90	0.85
Cost of equity (post tax) (%)	8.8	8.5
Debt premium	1.0	1.0
Cost of debt (pre tax) (%)	5.7	5.7
Tax rate (%)	30.0	30.0
Cost of debt (post tax) (%)	4.0	4.0
Gearing (%)	35.0	30.0
WACC (post tax) (%)	7.1	7.2
WACC (pre tax) (%)	**10.1**	**10.2**

Source: Ofcom, For Openreach, the risk free rate of 4.7% is ~120bps lower than the current 10-year bond rate in Australia.

Exhibit 28

Regulatory Calculations versus Market Perception

	Typical Regulatory Decision	Market's Perception
Risk-free rate (%)	5.75	5.75
Debt Risk Premium (%)	1.40	1.10
Cost of Debt (%)	7.15	6.85
Market Risk Premium (%)	6.00	6.00
Beta	1.00	0.60
Pre-Tax Cost of Equity (%)	11.8	9.4
Gamma	0.50	0.18
Tax Rate (%)	30	30
Debt to Assets (%)	**60**	**80**
Nominal, Pre-Tax WACC (%)	**9.82**	**7.97**
Forecast Inflation (%)	3.00	3.00
Real, Pre-Tax WACC (%)	6.62	4.82
RAB multiple due to WACC differential	1.37	
RAB multiple implied by the market		1.50

Source: Company data, Morgan Stanley Research

(b) Value of Services Business
Under our hypothetical scenario, we value the Services business at A$15.3bn. This is based on our EBITDA estimate of approximately A$2.2bn once the Networks are separated, and then we apply an EBITDA multiple of 7.0x.

Determining the earnings impact on the Service business once Networks are separated is another complicated exercise. Without Networks, we estimate the impact on Services business (retail + wholesale) earnings would be **negative** as Telstra would likely lose some cross subsidy benefits from not running an integrated model, loss of economies of scale and bundling advantages, and retail prices could come under further pressure as Telstra defends market share.

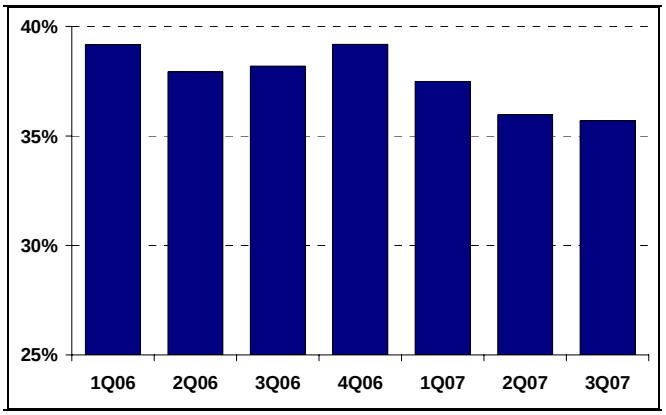
As highlighted in Exhibit 18, we estimate Telstra's Service business currently generates an EBITDA margin of 53% (based on our estimates of EBITDA margins for other businesses ranging from 10-50%).

We assume that once the Networks are established, Telstra's Service margins drop ~15% to 40%. Assuming there is no change in any of the other businesses, this translates to a 9% drop in earnings. BT also experienced a decline in 10% in its retail/wholesale margins in the first quarter when Openreach was established; however, its overall margins are around 30%, which is well below Telstra's current margins.

(c) Value of Other Businesses
We value Telstra's 'other' businesses at A$35.9bn – based on various EV/EBITDA multiples. The range of value is A$31.7bn to A$40.1bn.

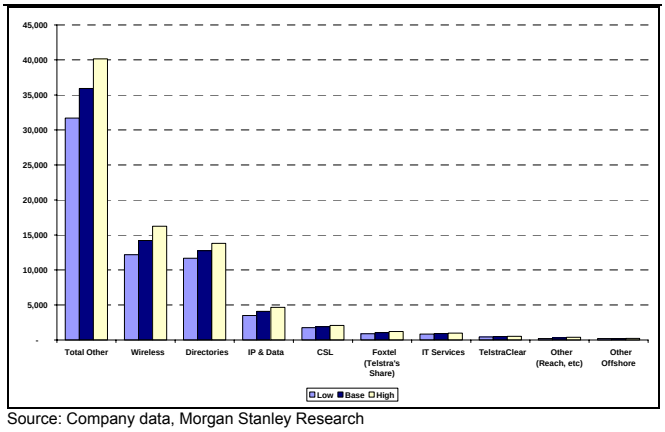
Although the 'other' businesses are almost 50% of the total value, the focus of this report is to review the risks and opportunities in the fixed-line broadband businesses, which are more exposed to regulation.

Exhibit 29
BT's OpenReach Margins



Source: Company data, Morgan Stanley Research

Exhibit 30
Value of Other Businesses (Ex Services/Networks)



Source: Company data, Morgan Stanley Research

Scenario Analysis

Now that we have explored the value of the hypothetical break-up of Telstra, we come back to current reality with our existing scenario analysis. We derive bear and bull case valuations of A$3.16 and A$5.47 per share, respectively, suggesting 28% downside and 24% upside from the current share price. Our key assumptions are summarized in Exhibit 31.

Bull Case Assumptions

- Mobile revenue growth of 4-5% over the next 4 years;
- Internet revenue growth of 13-19% pa;
- PSTN revenue decline of ~3% pa, implying fixed-line loss per annum of 2%, compared with our current forecast of a 3% decline;
- Cost growth of 1% pa;
- EBITDA margin of 44% by 2010;
- Long-run capex to sales ratio of 12%.

Bear Case Assumptions

- Mobile revenue growth of 2-3% over the next 4 years, and internet revenue growth of 9-16% pa;
- PSTN revenue decline of 5%, with fixed-line loss increase to 4-5% per annum;
- Cost growth of 3% pa;
- EBITDA margin of 41% by 2010;
- Long-run capex to sales ratio of 15%.

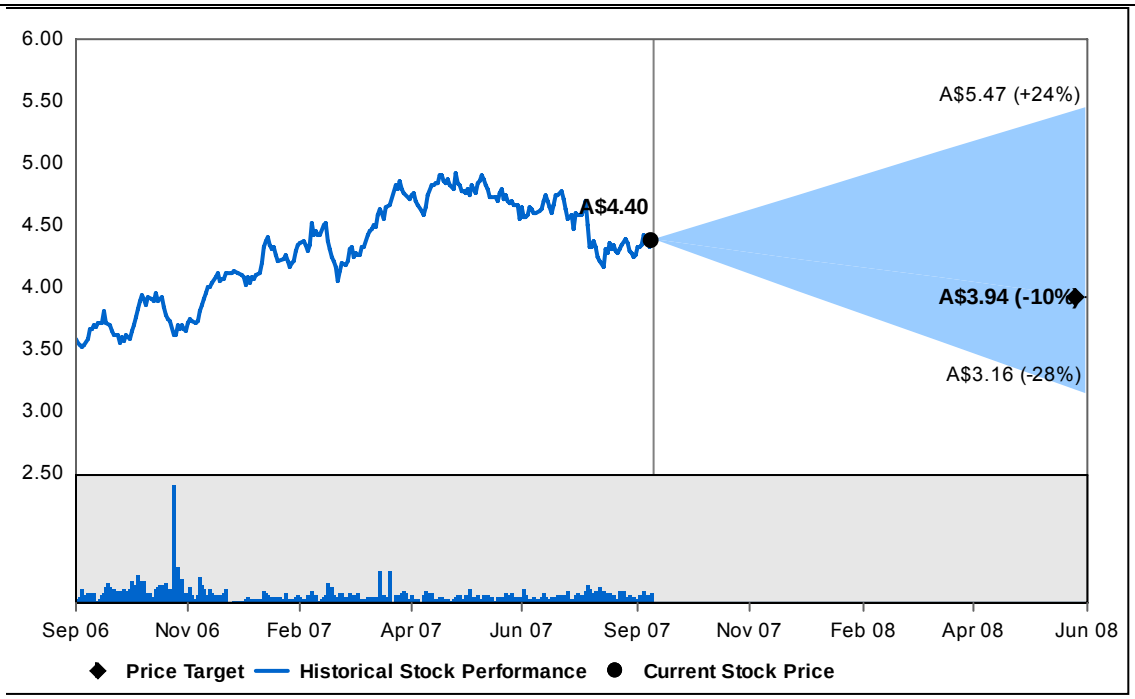
Exhibit 31

Summary of Scenario Analysis

	2008E	2009E	2010E
Revenue Growth			
Base Case (%)	3.3	1.8	1.1
Bull Case (%)	3.7	2.4	1.6
Bear Case (%)	2.7	1.2	0.5
Expense Growth			
Base Case (%)	5.0	2.6	0.8
Bull Case (%)	2.8	2.3	0.8
Bear Case (%)	5.0	3.3	0.8
EBITDA Growth			
Base Case (%)	0.9	0.6	1.5
Bull Case (%)	4.9	2.5	2.6
Bear Case (%)	-0.5	-1.6	0.0
EBITDA Margin			
Base Case (%)	42.2	41.7	41.9
Bull Case (%)	43.6	43.7	44.1
Bear Case (%)	41.8	40.7	40.5
EBIT Growth			
Base Case (%)	-2.2	-1.8	2.9
Bull Case (%)	4.4	2.1	5.4
Bear Case (%)	-4.5	-5.7	0.1
NPAT Growth			
Base Case (%)	-4.1	-3.5	4.8
Bull Case (%)	3.8	2.0	8.7
Bear Case (%)	-6.8	-8.5	0.8
Capex/ Sales			
Base Case (%)	20.1	18.5	14.2
Bull Case (%)	18.7	16.3	12.0
Bear Case (%)	20.2	19.3	15.0
RoIC			
Base Case (%)	16.3	15.8	16.6
Bull Case (%)	17.6	18.0	19.6
Bear Case (%)	15.9	14.8	15.0

E = Morgan Stanley Research estimates.
Source: Company data, Morgan Stanley Research

Exhibit 32
Telstra: Bull Case Implies 24% Upside; Bear Case 28% Downside



Source: FactSet, Morgan Stanley Research

Telstra Price Target and Risks

Our price target of A$3.94 is based on a DCF model, using a WACC of 9.10% and terminal growth rate of 1%. The major risks to our price target include the company's ability to execute its transformation strategy, rising competition, uncertain regulatory environment and the sustainability of the dividend. The upside risks include, higher than expected transformation benefits, competition remains benign, and the regulatory environment improves in Telstra's favor.

Exhibit 33
Telstra: DCF Valuation Summary

	A$mn	$ps
Total Company	61,573	4.95
Other Assets	1,200	0.10
Net Debt	(13,674)	-1.10
Equity Value	49,099	3.94

Source: Morgan Stanley Research

Company Description
Telstra Corp. Ltd. is the full-service incumbent telecommunications provider in Australia. The company offers a full range of local, domestic and international voice, video (including pay TV through Foxtel) and data services. Telstra operates national GSM and CDMA mobile networks

Australia Telecommunications

Industry View: Cautious
We believe rising competitive intensity in mobile and broadband is likely to reduce industry returns.

MSCI Country: Australia
Asia Strategist's Recommended Weight: 22.4%
MSCI Asia/Pac All Country Ex Jp Weight: 28.4%

MORGAN STANLEY ModelWare	**Morgan Stanley ModelWare is a proprietary analytic framework that helps clients uncover value, adjusting for distortions and ambiguities created by local accounting regulations.** For example, ModelWare EPS adjusts for one-time events, capitalizes operating leases (where their use is significant), and converts inventory from LIFO costing to a FIFO basis. ModelWare also emphasizes the separation of operating performance of a company from its financing for a more complete view of how a company generates earnings.

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(as of August 31, 2007)

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	Coverage Universe		Investment Banking Clients (IBC)		
Stock Rating Category	Count	% of Total	Count	% of Total IBC	% of Rating Category
Overweight/Buy	**934**	**41%**	**321**	**43%**	**34%**
Equal-weight/Hold	**1015**	**44%**	**328**	**44%**	**32%**
Underweight/Sell	**333**	**15%**	**92**	**12%**	**28%**
Total	**2,282**		**741**		

Data include common stock and ADRs currently assigned ratings. An investor's decision to buy or sell a stock should depend on individual circumstances (such as the investor's existing holdings) and other considerations. Investment Banking Clients are companies from whom Morgan Stanley or an affiliate received investment banking compensation in the last 12 months.

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Overweight (O or Over) - The stock's total return is expected to exceed the total return of the relevant country MSCI Index, on a risk-adjusted basis over the next 12-18 months.

Equal-weight (E or Equal) - The stock's total return is expected to be in line with the total return of the relevant country MSCI Index, on a risk-adjusted basis over the next 12-18 months.

Underweight (U or Under) - The stock's total return is expected to be below the total return of the relevant country MSCI Index, on a risk-adjusted basis, over the next 12-18 months.

More volatile (V) - We estimate that this stock has more than a 25% chance of a price move (up or down) of more than 25% in a month, based on a quantitative assessment of historical data, or in the analyst's view, it is likely to become materially more volatile over the next 1-12 months compared with the past three years. Stocks with less than one year of trading history are automatically rated as more volatile (unless otherwise noted). We note that securities that we do not currently consider "more volatile" can still perform in that manner.

Unless otherwise specified, the time frame for price targets included in this report is 12 to 18 months.

Analyst Industry Views

Attractive (A): The analyst expects the performance of his or her industry coverage universe over the next 12-18 months to be attractive vs. the relevant broad market benchmark, as indicated below.

In-Line (I): The analyst expects the performance of his or her industry coverage universe over the next 12-18 months to be in line with the relevant broad market benchmark, as indicated below.

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Benchmarks for each region are as follows: North America - S&P 500; Latin America - relevant MSCI country index or MSCI Latin America Index; Europe - MSCI Europe; Japan - TOPIX; Asia - relevant MSCI country index.

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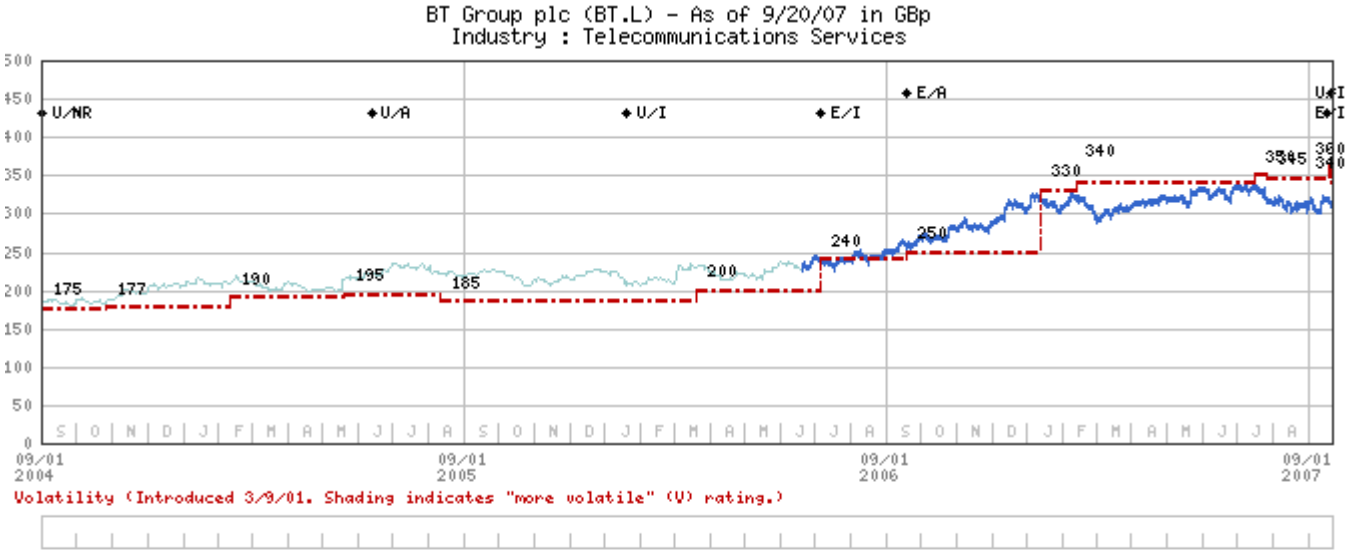
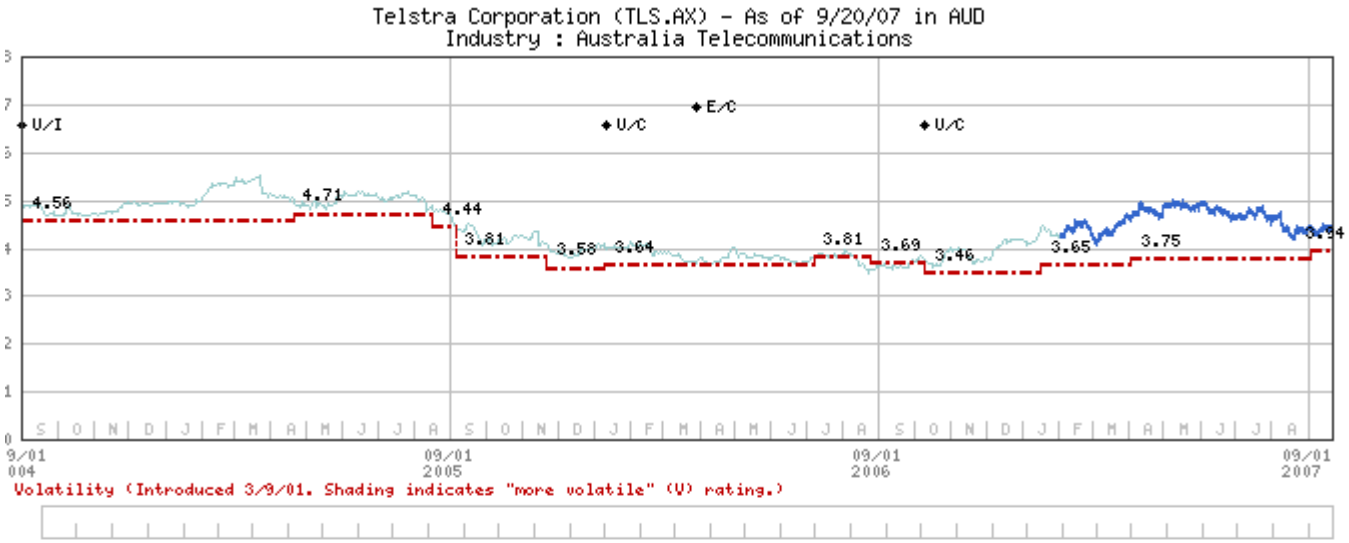
Stock Price, Price Target and Rating History (See Rating Definitions)



Stock Rating History: 9/1/04 : U/NR; 6/13/05 : U/A; 1/19/06 : U/I; 7/6/06 : E/I; 9/19/06 : E/A; 9/17/07 : E/I; 9/20/07 : U/I

Price Target History: 7/30/04 : 175; 10/26/04 : 177; 2/11/05 : 190; 5/20/05 : 195; 8/11/05 : 185; 3/21/06 : 200; 7/6/06 : 240; 9/19/06 : 250; 1/12/07 : 330; 2/12/07 : 340; 7/17/07 : 350; 7/27/07 : 345; 9/18/07 : 360; 9/20/07 : 340

Source: Morgan Stanley Research Date Format : MM/DD/YY Price Target No Price Target Assigned (NA)
Stock Price (Not Covered by Current Analyst) Stock Price (Covered by Current Analyst)
Stock Ratings abbreviated as below (Effective 3/18/02, ratings appear as Stock Ratings/Industry View) ♦
Stock Ratings as of 3/18/02: Overweight (O) Equal-weight (E) Underweight (U) More Volatile (V) No Rating Available (NAV)
Stock Ratings prior to 3/18/02: Strong Buy (SB) Outperform (OP) Neutral (N) Underperform (UP) No Rating Available (NAV)
Industry View: Attractive (A) In-line (I) Cautious (C) No Rating (NR)



Stock Rating History: 9/1/04 : U/I; 1/11/06 : U/C; 3/29/06 : E/C; 10/9/06 : U/C

Price Target History: 8/13/04 : 4.56; 4/20/05 : 4.71; 8/17/05 : 4.44; 9/5/05 : 3.81; 11/22/05 : 3.58; 1/10/06 : 3.64; 7/7/06 : 3.81; 8/25/06 : 3.69; 10/9/06 : 3.46; 1/17/07 : 3.65; 4/3/07 : 3.75; 9/3/07 : 3.94

Source: Morgan Stanley Research Date Format : MM/DD/YY Price Target No Price Target Assigned (NA)
Stock Price (Not Covered by Current Analyst) Stock Price (Covered by Current Analyst)
Stock Ratings abbreviated as below (Effective 3/18/02, ratings appear as Stock Ratings/Industry View) ♦
Stock Ratings as of 3/18/02: Overweight (O) Equal-weight (E) Underweight (U) More Volatile (V) No Rating Available (NAV)
Stock Ratings prior to 3/18/02: Strong Buy (SB) Outperform (OP) Neutral (N) Underperform (UP) No Rating Available (NAV)
Industry View: Attractive (A) In-line (I) Cautious (C) No Rating (NR)

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Industry Coverage:Australia Telecommunications

Company (Ticker)	Rating (as of)	Price (09/20/2007)
Sachin Gupta, CFA		
Telstra Corporation (TLS.AX)	U (10/09/2006)	A$4.4

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