# The End of the "Last Good Telco Market"?

November 3, 2018 by Chris Hoare

DoCoMo's announcement on Wednesday evening that the Japanese market leader intends to give back up to ¥400bn in discounts to consumers, offering cheap plans at a 20-40% price cut to existing levels has derailed what until this week had been perceived as the last large good market for telco investors, where all three operators generate a return well above their cost of capital. The response in share price terms was savage: at the low point of trading on Thursday, DoCoMo's share price had lost 44% of all the gains made over its 6 year bull run from 2012 to its recent high. So, what should investors in Japanese telcos do from here? Is Japan over? Are, as we heard a number of investors say in the last 2-3 days, Japanese telcos headed to multiples similar to those the Chinese operators trade on?

Before we try to answer these questions we need to be clear: visibility is poor. However, we think three things are important, and suggest the price response may have been an over-reaction:

- DoCoMo themselves state in their announcement that consumer behaviour (trading up) may limit the reduction in ARPU. KDDI is defending price levels and claimed on their call that they have already given back ¥300bn of customer returns since introducing their own discount plans, with individual plans incorporating 30% price cuts, yet group revenues are growing, and ARPUs are only down 1-2% annually. What will Softbank do, given 4.4x leverage and the need for domestic telco cash flow to be sustained, and their desire to IPO SB KK? Their response is more likely to follow KDDI's than DCM's in our view. If only 1 operator is cutting price materially, is this the beginning of a price war?
- DoCoMo compounded the price cutting announcement with a substantial medium term profit warning. The key figure in this in our view was their estimate that operating profit will recover to FY 17 & 18 levels of ¥990bn by FY 23. We think that if DoCoMo had not given this figure or the associated guidance of ¥5trn revenues by 2021 the market would not have responded so negatively to the price cutting.
- When DoCoMo gave their guidance they would have been aware the Rakuten roaming deal was going to KDDI. This deal implies a transfer of perhaps ¥80-100bn revenues away from DoCoMo (and a somewhat smaller figure accruing to KDDI over time) in our view as wholesale MVNO revenues currently with the leader transfer to roaming revenues with the number 2. DoCoMo's 2023 guidance probably reflected the likely loss of these wholesale revenues, but this got lost in the pricing announcement.

We do not think Japanese ARPU is about to fall anything like 40% or even 20%. ARPUs are under pressure, not least as Rakuten launches in October 2019 (although we think there is some chance of a rethink of strategy by the new entrant, given DoCoMo's scorched earth strategy), and revenue growth is turning negative. Long term regulatory risk is higher than we previously assumed. However, capex is likely to remain contained and costs can be cut through digitisation. Separating handsets and monthly fees could even be NPV positive. We think worst fears evinced by the share price falls on Thursday are overdone. However, all Japanese telcos sold off indiscriminately with the result that stock by stock we would take different approaches to the current situation:

We cut our recommendation to Neutral on DoCoMo (HERE). DoCoMo's approach to the price cutting and lack of detail was poor in our view. The company is likely to attract a lower multiple going forward to reflect both regulatory risk and the fact that the government owned operator is the one who has caved to government pressure. On our lowered estimates the valuation does not look particularly attractive on 13.3x current year earnings, rising to 17.1x next year.

For KDDI we think at 9.2x FY 18 earnings the price fall is overdone and retain our Buy but cut our price target to ¥4,100 (see HERE). At current price levels a substantial earnings decline is priced in, one which we think may not happen. KDDI is the hero's choice in Japan in our view. IF earnings don't fall substantially next year KDDI has the potential to deliver a healthy return in the next 12-18 months in our view from current levels.

Can Softbank still IPO its domestic mobile business given the lack of visibility? We think it will now be a struggle, certainly at previously mooted valuations of $80-90bn, which were heavily dependent on a yield premium driving a valuation premium. The yield premium just collapsed given the decline in share prices elsewhere in the sector and in any event with earnings in decline does the structure (high leverage and 100% payout ratio) even work? Would investors require a discount for this structure given the risk rather than a premium for the yield?

Finally, for NTT, although we are more cautious on DoCoMo, we still see the potential for NTT to outperform. The rump value (everything ex DoCoMo) has now fallen to below ¥7trn, yet we see positive outcomes on the fixed line. The large share buyback at DoCoMo also opens the possibility of a very large buyback at the parent too. As we wrote (HERE) we are bullish. NTT remains our top pick among the Japanese telcos.

*For the full weekly review and updated comp sheets, see HERE.*

**Full 12-month historical recommendation changes are available on request**

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