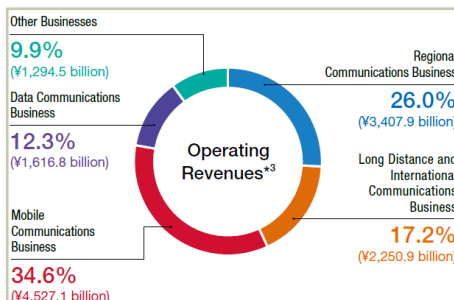


## NIPPON TELEGRAPH & TELEPHONE (9432:TYO)

### SECTOR: TELECOMS (LARGE-CAP)

**Current Price:** ¥5101  
**1 YR Change:** +8.11%  
**Incorporation:** Japan  
**Beta (Public Source):** 0.4422  
**Valuation Type:** Value



### Company Description

Nippon Telegraph & Telephone is a provider of fixed and mobile voice related services, Internet Protocol (IP)/packet communications services, telecommunications equipment, system integration and other telecommunications-related services in Japan. The Company operates in five segments: regional communications business, long distance and international communications business, mobile communications business, data communications business and other business, which comprises building maintenance, real estate rentals, systems development and other services related to research and development. Incorporated in 1985, the Japanese Govt is still the maj. shareholder (35%)

### SWOT

| Strength   | Weaknesses   |
|--|--|
| <ul style="list-style-type: none"> <li>- Falling Debt/Capital Ratio over time</li> <li>- Strong market share</li> </ul>  | <ul style="list-style-type: none"> <li>- Falling EBITDA Margin</li> <li>- Falling Local Landline subscriptions</li> <li>- Conglomerate; too many subsidiaries</li> <li>- Low ROIC</li> </ul> |
| Opportunities  | Threats  |
| <ul style="list-style-type: none"> <li>- Capex streamlining = more free cash flow</li> <li>- Buybacks &amp; Cost Cutting</li> <li>- Overseas growth through M&amp;A</li> <li>- Cheaper than KDDI on free cashflow basis</li> </ul> | <ul style="list-style-type: none"> <li>- Japan.</li> <li>- KDDI much better in terms of profitability.</li> </ul>  |

### Poor Man's Valuation:

| (millions ¥)                 | Cash From Ops 5 Years | Capex 5 Years | Free Cash Flow 5 Years | Net Assets Value (m) | WACC | Shares Out. (m) | Debt (m)  | Exp. Market Cap. | Share Price | Cheap or Expensive |
|------------------------------|-----------------------|---------------|------------------------|----------------------|------|-----------------|-----------|------------------|-------------|--------------------|
| <b>Basic Valuation</b>       |                       |               |                        |                      |      |                 |           |                  |             |                    |
| Historical                   | 12,795,570            | 9,181,872     | 3,613,698              | 883,380.6            |      |                 |           |                  | ¥5,101      | Fairly Valued      |
| Forecasted                   |                       |               |                        |                      |      |                 |           |                  |             |                    |
| Base Case 20 Years           | 51,182,280            | 36,727,488    | 14,454,792             | 883,380.6            | 10%  | 2,100           | 419,497.7 | 10,265,410       | ¥4,888      | -4%                |
| Bull 20 Year Forecast (+40%) | 71,655,192            | 51,418,483    | 20,236,709             | 883,380.6            | 10%  | 2,100           | 419,497.7 | 13,855,526       | ¥6,598      | 29%                |
| Bear 20 Year Forecast (-40%) | 30,709,368            | 22,036,493    | 8,672,875              | 883,380.6            | 10%  | 2,100           | 419,497.7 | 6,675,295        | ¥3,179      | -38%               |

### Investment Summary

After stalking the company for a few months, I believe that it is - still - a bit cheap to fairly valued. An outstanding cashflow generator with excellent balance sheet, the company has a diversified portfolio and a long history. The business is doing fine overall with fixed line national business in decline whereas all other segments are recording growth or are very much stable. Two high capex segments have been earmarked for capex reduction which will increase free cashflows. Debt has been gradually falling over the years, whereas M&A Activity is planned especially for international and data communications segment. The company has consistently increased the dividend payout ratio from 17% in 2006 to 38% in 2016 and has repurchased about ¥2.9 trillion of stock in 14 years. Last year's repurchase - as of August 2016 - was ¥267 billion and is now expected to take the total cumulative figure to ¥3.1 trillion by the end of 2017. Most importantly, if you sum the cash on balance sheet and net PPE and divide by the shares outstanding, you get the current market cap. While KDDI is far better in profitability, it trades expensive than Nippon Telegraph & Telephone.

### FAIRLY VALUED

|                         |         |
|-------------------------|---------|
| Average volume (m)      | 4.11m   |
| Shares outstanding (bn) | 2.10bn  |
| Free float (bn)         | 1.41bn  |
| P/E (TTM)               | 12.66   |
| Market cap JPY          | 10.69tn |
| EPS (TTM)               | 402.79  |

### VALUATION

|                         |          |
|-------------------------|----------|
| Base Growth Rate        | 1%       |
| Wacc                    | 10%      |
| Forecast Period FCF (m) | 4693104  |
| Terminal value (m)      | 14708297 |
| PV terminal value (m)   | 9132695  |
| EV (m)                  | 13825800 |
| Debt (m)                | 4194977  |
| Cash (m)                | 1121351  |
| Equity Value (m)        | 10752174 |
| Shares Outstanding (m)  | 2105.8   |

Fair Value Share Price **¥5,106**

### FINANCIALS

|                        |       |
|------------------------|-------|
| ROE 5yr avg.           | 6.75% |
| ROIC 5yr avg.          | 4.64% |
| Interest Coverage 2016 | 32.90 |
| FCF Yield 2017e        | 11.0% |

## Business Model & Segments Source: Annual Report/Company Website

### Business Model & Strategy

#### Review of Financial Targets in the Medium-Term Management Strategy, "Towards the Next Stage 2.0"

| Category   | Financial targets to be achieved by the fiscal year ending March 31, 2018 |
|--|---|
| ● <b>EPS Growth</b>  | At least ¥350 ⇒ <b>At least ¥400</b>                                      |
| ● <b>Overseas Sales / Operating Income</b>   | \$22.0 billion / \$1.5 billion  |
| ● <b>Streamlining Capital Investment</b><br>(in domestic network business) [vs. FY ended March 31, 2015] | At least ¥200.0 billion   |
| ● <b>Cost Reductions</b><br>(fixed-line / mobile access networks)<br>[vs. FY ended March 31, 2015]       | At least ¥600.0 billion ⇒<br><b>At least ¥800.0 billion</b>               |

**Notes:**

- 1 Overseas operating income excludes M&A-related temporary expenses, such as depreciation costs of intangible fixed assets.
- 2 Streamlining capital investment (in domestic network business) excludes capital investment for NTT Communications' data centers and certain other assets.
- 3 Figures for cost reductions (fixed-line / mobile access networks) are financial targets that exclude the impact of the change in the depreciation method for property, plant and equipment.
- 4 Financial targets for overseas sales and overseas operating income and for streamlining capital investment have not been revised.

- The company strategy is relatively simple: cut costs in the declining local landline market and expand (through M&A) abroad. Overseas revenues 2018 target is set at \$22bn as compared to \$15.6bn in 2016.
- Reducing capex in the highest capital consuming – local – business. Local Business capex stands at 18% of segment's operating revenues. With the segment's operating income share as percentage of total business op. income around 20%, reducing capex will surely give boost to total free cash flows of the firm.

### Segments

#### **Regional Communications:** 26% of Total Op. Revenues | 19.8% of Op. Income | 36.9% of Total Capex

- The fastest declining segment, long term outlook is very bleak and the company now intends to slash capex to churn out free cashflows. Fixed line subscriptions have halved over the decade whereas broadband subscriptions appearing to have peaked. While Revenue has fallen, operating income has increased over years indicating efficiency gains.

#### **International Communications:** 17.2% of Total Op. Revenues | 7.2% of Op. Income | 13.5% of Total Capex

- Segment includes cloud services and data centers across globe. Total revenues have been consistently rising but operating profits have been falling continuously indicating inefficiencies. Strategy includes expansion in Asia and U.S with data centers. Currently the segment appears to be a drag on operating income.

#### **Mobile Communications Business:** 34.6% of Total Op. Revenues | 59% of Op. Income | 35.3% of Total Capex

- Segment contributes the most to total revenues whereas topline and operating income has been flat over the last five years. Highly capital intensive, any reduction in un-necessary capex will improve free cash flow. I do feel an international acquisition for this segment is in pipeline in the current year.

#### **Data Communications Business:** 12.3% of Total Op. Revenues | 8.4% of Op. Income | 7.9% of Total Capex

- Segment includes financial and IT consulting whereas recently the segment has seen high M&A activity. Carlisle & Gallagher Consulting from U.S for financial IT consulting and Dell Services Division for healthcare consulting was acquired. Capex light and with stable rising operating income, the segment will undergo further M&A in coming times.

#### **Other Businesses:** 9.9% of Total Op. Revenues | 5.6% of Op. Income | 6.4% of Total Capex

- Segment provides services related to the real estate, finance, construction and electric power and system development businesses. From real estate development to system integration and leasing services, the segment is non-core and may well be sold out one day. Revenue is flat for five years but with rising operating profits.

## Model & Assumptions

| Revenues                      | 2015   | 2016   | 2017e  | 2018e  | 2019e  | 2020e  | 2021e  |
|-------------------------------|--------|--------|--------|--------|--------|--------|--------|
| <b>Total Revenue (bn)</b>     | 11,095 | 11,541 | 11,815 | 12,112 | 12,429 | 12,787 | 13,119 |
| % Growth                      | 1.6%   | 4.0%   | 2.4%   | 2.5%   | 2.6%   | 2.9%   | 2.6%   |
| <b>EBIT (bn)</b>              | 1,085  | 1,348  | 1,380  | 1,415  | 1,452  | 1,494  | 1,533  |
| % Sales                       | 9.77%  | 11.68% | 11.68% | 11.68% | 11.68% | 11.68% | 11.68% |
| <b>Capex (bn)</b>             | 1,803  | 1,638  | 1,536  | 1,575  | 1,616  | 1,662  | 1,706  |
| % Sales                       | 16%    | 14%    | 13%    | 13%    | 13%    | 13%    | 13%    |
| <b>Dep. &amp; Amort. (bn)</b> | 1,831  | 1,779  | 1,822  | 1,867  | 1,916  | 1,971  | 2,023  |
| % Sales                       | 17%    | 15%    | 15%    | 15%    | 15%    | 15%    | 15%    |

### Explanation

- > Modest Revenue growth on the basis of overseas M&A.
- > Capex expected to fall and I keep it constant at 13%, lower than 2016.
- > EBIT and Depreciation kept constant going forward.

## Reporting Quality

|   |                   |
|---|-------------------|
| Annual Report                             | Comprehensive     |
| Auditor's Opinion for Parent Organization | KPMG AZSA: Clear. |
| ESG & Sustainability reporting            | Extensive.        |

### Explanation

- > Auditors opinion is clear.
- > Company is extensively involved in ESG assessment, ranging from diversity to environment footprint mapping.

|  |     |
|--|-----|
| ESG Materiality Matrix Reported & Assessed         | Yes |
| Quantitative Identification of all key ESG metrics | Yes |

#### Usefulness of ESG metrics in current scenario?

Has a direct effect on recruitment as diversity brings a range of different ideas at work place. CO<sub>2</sub> emissions have declined in 2016 indicating that company is getting policies in place. No consideration in upside/downside calculations.

### Conclusion

- > Good company that is still relatively cheap. Lowering capex is expected to increase free cashflow whereas company has consistently increased the dividend payout ratio from 17% in 2006 to 38% in 2016 and has repurchased about ¥2.9 trillion of stock in 14 years. Last year's repurchase - as of August 2016 - was ¥267 billion and is now expected to take the total cumulative figure to ¥3.1 trillion by the end of 2017. With falling debt, M&A opportunities planned and valuation appearing cheap on free cash flows, the company makes a very valid investment case.