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Netlink NBN Trust

The fibre landlord

SINGAPORE |TELECOMMUNICATION| INITIATION

27 March 2019

- Sole network provider of residential fibre broadband in Singapore
- Stable and recurrent cash-flows from a customer base of 1.3mn
- Future growth from NBAP and non-residential end-user connections
- We initiate coverage on NLT with a target price of S$0.89. We used a DCF approach in our valuation because of the regular stream of cash generated from NLT's fibre business. Our valuation is based on a WACC of 6% and a terminal growth rate of 1%.

Company background

Netlink NBN Trust (NLT) is the only fibre network with nationwide residential coverage in Singapore. NLT designs, builds, owns and operates the passive fibre network infrastructure which includes ducts, manholes, fibre cables and central offices. As of 31 December 18, NLT supports close to 1.3mn residential end-user connections and more than 45,000 non-residential end-user connections and 1,462 Non-Building Address Point (NBAP) across Singapore. NLT owns more than 16,000 km of ducts, 62,000 manholes, 76,000 km of fibre cables and 33,000sqm of co-location space.

Investment thesis

1. **Sole network provider of residential fibre broadband in Singapore.** NLT nationwide residential coverage in Singapore accounts for about 60% of its revenue. The asset base of more than S$3bn and the duration needed to build a comparable network across Singapore, will pose a major barrier to entry. Any meaningful return on investment would be a challenge without similar financial assistance from the Singapore government. Under iN2015, NLT received an aggregate grant worth of S$732mn.

2. **Stable and predictable revenue stream.** We believe NLT enjoys a resilient business model because the majority of its revenue is derived from recurring subscription fees (~67%) from residential and non-residential fibre connections. In the long run, the residential segment is pegged to new homes build or population growth. Growth could also stem from dual fibre connections per household. Cancellation of connections is rare. In the medium term, growth in residential connections is being propelled by migration of legacy Asymmetric Digital Subscriber Line (ADSL) and Hybrid Fibre Coaxial (HFC) connections to fibre. We project the residential segment to grow 11.5% to 1.4mn connections and the non-residential segment to grow 5.3% YoY to 48,800 connections in FY20e.

3. **Future growth from NBAP and non-residential connections.** Although revenue contribution from NBAP is still modest (~2% of revenue) we expect government smart nation initiatives to propel growth. We project a 41% YoY growth rate in FY20e. Non-residential connections provide an additional avenue for growth. Demand is expected to come from SMEs as they upgrade to fibre for cloud-based applications. However, there is competition from retail service providers (RSPs) with their own fibre infrastructure and competes directly with NLT. Hence, we are more conservative with our projections and give a 5.3% YoY growth rate for FY20e.

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ACCUMULATE(Initiation)

CLOSING PRICE	SGD 0.825
FORECAST DIV	SGD 0.047
TARGET PRICE	SGD 0.890
TOTAL RETURN	13.5%

COMPANY DATA

O/S SHARES (MN) :	3,897
MARKET CAP (USD mn / SGD mn) :	2380 / 3215
52 - WK HI/LO (SGD) :	0.83 / 0.73
3M Average Daily T/O (mn) :	5.89

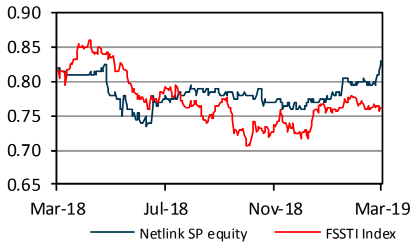
MAJOR SHAREHOLDERS (%)

Singtel Interactive Pte Ltd	24.8%

PRICE PERFORMANCE (%)

	1MTH	3MTH	1YR
COMPANY	2.5	6.5	6.7
STI RETURN	(2.5)	4.7	(3.5)

PRICE VS. STI



Source: Bloomberg, PSR

KEY FINANCIALS

Y/E Mar, SGD mn	FY17	FY18	FY19e	FY20e
Revenue	299	229	357	393
EBITDA	214	167	247	268
Net Profit	79	50	77	92
Distribution Yield	2.5%	4.0%	5.7%	6.4%
ROE (x)	2.6%	1.6%	2.4%	3.0%
ROA (x)	1.9%	1.1%	1.8%	2.1%

Source: Company, PSR

VALUATION METHOD

DCF (WACC: 6%, Terminal growth: 1%)

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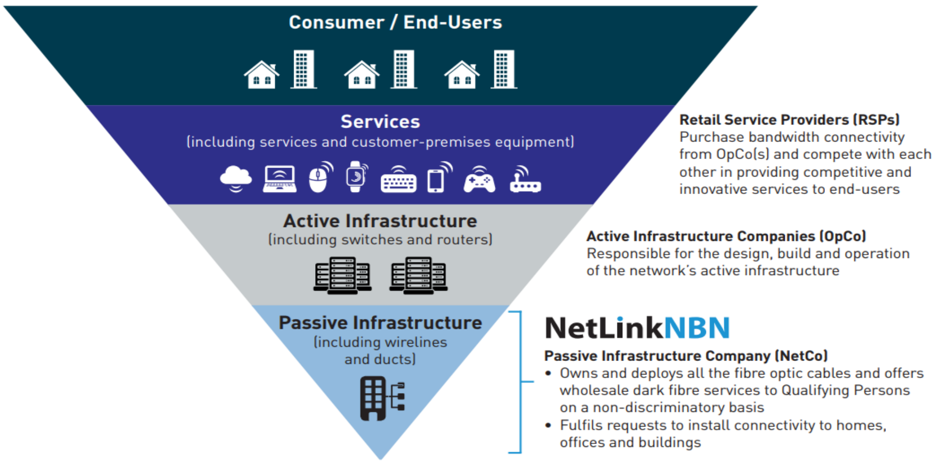
MCI (P) 062/10/2018
Ref. No.: SG2019_0057

Drivers of the demand for fibre

1. **Increased data consumption.** Increasing demand for high speed and low latency broadband service for online video streaming and audio services, video communications, cloud service and internet of things.
2. **Growth in market size.** Growth in population, household and residential premises, demand for multiple subscriptions, growth in enterprises and office space, demand from mobile telco operators.
3. **Migration from older technologies to fibre.** Migration of users from older broadband technology such as ADSL and HFC. Starhub will contribute ~80,000 migrations in 2019.
4. **Government initiatives.**
   - COPIF 2013: New residential units with planning permit after May 2013 are required to have at least one fibre termination point pre-installed
   - Increase in number of hotspots for Wireless@SG
   - Fibre Ready Scheme: Subsidised one-time installation for in-building fibre for non-residential
   - Grants to improve productivity and performance of SMEs through adopting new technology

Figure 1: Industry structure

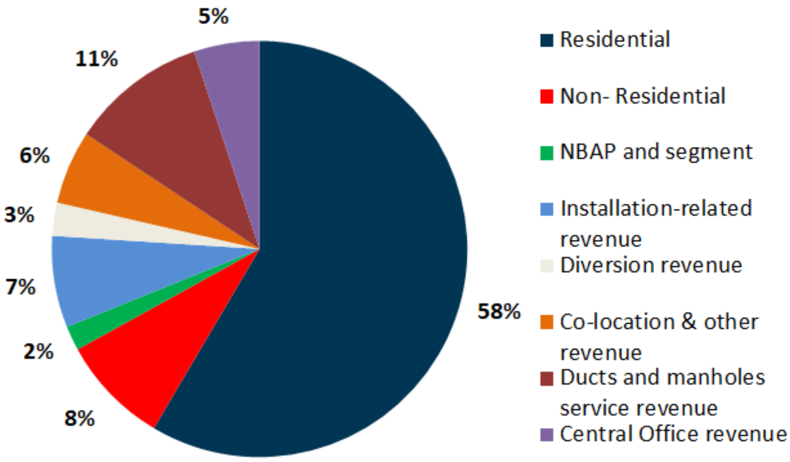


Source: Company

Revenue

NLT has two streams of revenue namely fibre and non-fibre. Fibre revenue includes residential, non-residential, NBAP, installation-related, diversion and co-location. Non-fibre includes ducts & manholes service revenue and central office revenue. ~80% of revenue is regulated under the Regulated Asset Base (RAB) model. (see regulated pricing)

Figure 2: Revenue breakdown as at 3Q19



Source: Company, PSR

Timeline

2008 – OpenNet established as a consortium among Singtel, SPH, SP telecom and Axia NetMedia corp

2009 – Issued licence by IMDA to install, operate and maintain the passive infrastructure and systems of the Next Gen NBN

2011 – NLT was established. Majority of the passive non-fibre infrastructure assets comprising underground ducts, manholes, and central offices were transferred to NLT from Singtel

2012 – Next Gen NBN was deployed to 95% of all residential homes and non-residential premises

2013 – NLT acquired OpenNet increased its assets to include OpenNet's fibre network

2014 – Additional passive non-fibre infrastructure were transferred to NLT from Singtel Integration of fibre infrastructure and related Singtel assets into NLT was completed

2016 – One million home subscribers

2017 – Remaining passive non-fibre infrastructure assets were transferred to NLT from Singtel, NetLink NBN Trust was established, listed on mainboard of the SGX

Fibre business

Residential (58% of revenue) – RAB

Residential fibre currently supports 1.28mn fibre end user connections. Each end user typically pays a monthly recurring charge (MRC) for the use of NLT fibre network through an RSP like Singtel (Figure 3). This revenue becomes the core of NLTs stable and predictable revenue stream. We project residential connections to grow 11.5% to 1.43mn by FY20e. The growth is attributable to migration of older technologies like ADSL and HFC to fibre connecting up remaining ~2% of Singapore's residential network. According to Media Partners Asia (MPA) an industry consultant, Singapore will reach the 100% coverage for fibre connection by 2020. In the long run, we expect growth to be pegged to organic household growth or population growth. Hence, we have incorporated growth from new homes built into our model including after reaching 100% coverage (~20,000 homes/ year).

Figure 3: MRC paid thru RSPs

Monthly recurring charge for fibre	(S$)
Residential	13.8
Non- Residential	55
NBAP and segment	73.8

Source: Company

Non-Residential (8% of revenue) – RAB

As of 3Q19 there are 45,734 connections to businesses, shopping malls, hospitals and schools, and these non-residential customers pay S$55/mth (Figure 3). NLT is well positioned to benefit from growth in this segment because of its extensive network that allows access to non-residential end users in a cost-efficient manner. In the medium term, we expect the segment to benefit from government initiatives and grants like the Fibre Ready Scheme to promote improvement in productivity through digitisation. RSPs have their very own fibre infrastructure and compete directly with NLT. We assume a more conservative growth to non-residential of 5.3% YoY in FY20e.

Non-Building Address Point (2% of revenue) – RAB

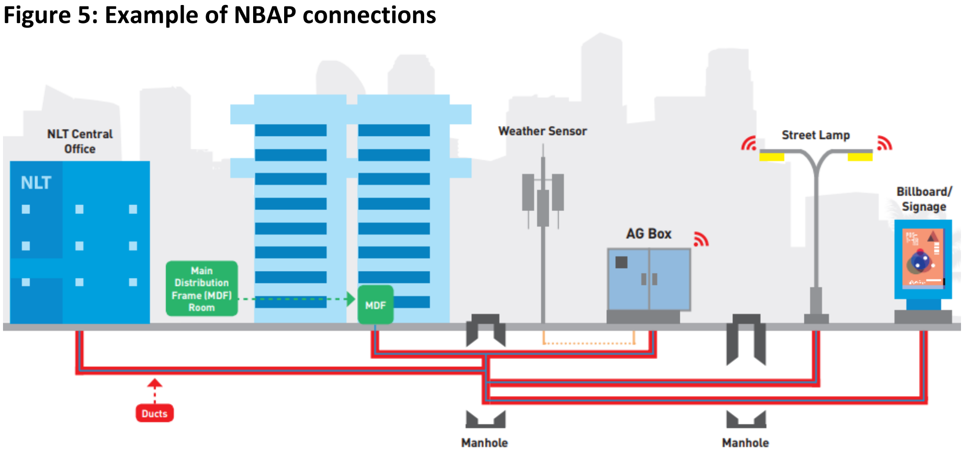
NBAP refers to a location that does not have a physical address or assigned postal code. Such locations can include bus stops, lamp posts, multi-storey carparks and traffic lights. NLT typically charges S$73.8 per NBAP connection (Figure 3). NBAP is used for applications such as wireless network base stations, cameras and sensors. These connections are essential in collecting real-time data from a network of sensors (e.g. monitoring weather conditions). Contributions from NBAP are still modest and we expect government initiatives like the next phase of wireless@SG, potential introduction of Heterogeneous network (HetNet) and 5G network to propel growth. We project a 41% YoY growth in NBAP connections to 2,063 from 1,462 in FY20e. We expect higher growth and demand for NBAP connections with the progressive rollout of smart nation programmes.

Figure 4: Smart nation initiatives

	Agencies:
1. Smart Mobility 2030	LTA
2. Smart HDB Town Framework	HDB
3. Integrated Estate Management System	JTC

Source: Company

Figure 5: Example of NBAP connections



Source: Company

Installation (7% of revenue) – Non-RAB

Installation related revenue comprises of one-time charges for the installation of a termination point at residential, non-residential and NBAP connections. Charges include new, relocation, repair, replacement or removal of existing termination points and fibre. Installation charges (Figure 6) and new service activation charges are typically paid by RSPs. New service activation charges are S$53 and S$64 per connection for residential and non-residential/NBAP respectively.

Figure 6: Installation charges

	(S$)
Residential	
High-rise	150
Landed	270
Non- Residential	
CO to termination point	717
CO to Vertical telecom riser	494

Source: Company

Diversion (2% of revenue) – Non-RAB

Diversion revenue is generated upon request from third parties such as developers and the Land Transport Authority for the diversion of NLT's ducts, manholes and fibre cables. Diversions include events such as road works, construction of MRT infrastructure and tunnels and building construction. Diversion revenue is not predictable because of its ad hoc nature.

Co-location & others (6% of revenue) – Non-RAB

The growth in co-location revenue is based on overall end-user demand for fibre connection services. Mainly comprises of MRCs received from Requesting Licensees to use space in co-location rooms in central offices to store their equipment racks, power, cooling and project study works.

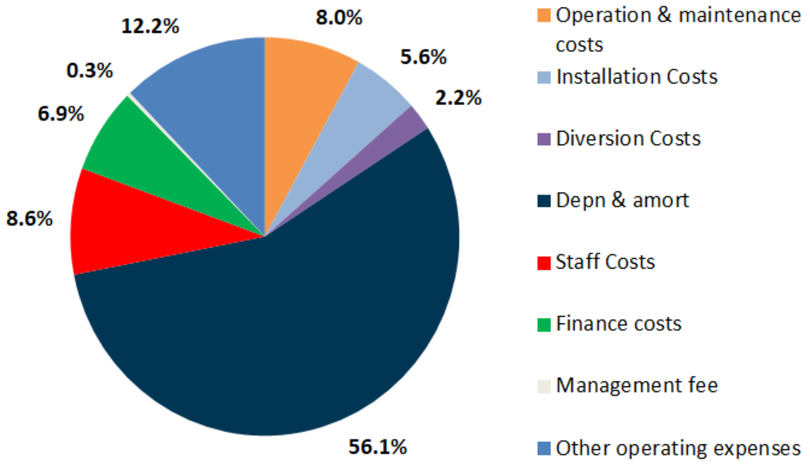
Non - Fibre business

Ducts & manholes & central office (15% of revenue)

Majority of Ducts & manhole service revenue is from Singtel. Sales are generated when Singtel uses the ducts & manholes spaces for its business needs. The central office revenue is mainly revenue received from Singtel for the leasing of space and equipment at the central offices for security, maintenance & administration. Ducts & manholes are under the RAB model while the central office is non-RAB.

Expenses

Figure 7: Breakdown of expenses as at 3Q19



Source: Company, PSR

Operation & maintenance

Operation and maintenance costs include the maintenance expense of NLT's network of ducts & manholes, fibre and central office, utilities, property management fees and warehouse management fees.

Installation costs & Diversion costs

Installation costs are driven by residential, non-residential and NBAP end user connections. Costs should be in tandem with installation revenues. Diversion expenses are pegged to diversion revenue and it tracks close to 70% of revenue.

Depreciation & amortisation

NLT possesses significant investments in its fibre infrastructure which translates into high depreciation charges. Depreciation is the largest expense item, accounting for 56% of the total expense. NLT uses straight-line depreciation method for its network assets that have a useful life ranging from 23 - 50 years. Amortisation of license fees totals S$10mn p.a. using the straight-line method over 23 years. There is no impact on distributions as these items are non-cash in nature.

Staff Costs

Staff cost is rising due to increasing headcount attributed to larger scale of NLT's operations. Staff costs have crept up since IPO from 7% to 8% of total expenses. We expect staff costs to remain stable in FY20e.

Balance sheet

Property Plant & Equipment (PPE)

Given NLT's extensive network infrastructure, PPE is the largest item in its balance sheets. NLT's PPE comprises of more than 16,000km of ducts, 62,000 manholes and 76,000 fibre cables. Alongside with leasehold land and buildings, exchange equipment, furniture, fittings and equipment and motor vehicles. Useful life ranges from 23-50 years for network assets.

Loans

Net gearing is expected to be 13% in FY20e. The loans are mainly committed revolving credit facility (RCF) and term loans. The S$210mn 3-year RCF matures in June 2020 and the S$510mn term loan matures in March 2020.

Regulated pricing

Interconnection offers (ICO) are prices set by Info-communications Media Development Authority (IMDA) and are regulated using the RAB model. Current prices are subjected for review in 2022.

NLT can recover these cost components:

1. Return of capital deployed (e.g. depreciation)
2. Operating expenditure
3. Return on capital employed

Assumptions in the RAB model:

(a) Base year of RAB is 2012. Assets purchased up to and including 2012 are valued at 2012 prices, assets purchased after 2012 are valued at actual cost. Depreciation for useful life for ducts & manholes is 35 years and fibre is 25 years.

(b) The return on capital is based on nominal pre-tax weighted average cost of capital (WACC) derived using the Capital Asset Pricing Model (CAPM) approach. Pre-tax WACC is 7% starting Jan 18. IMDA may change pre-tax WACC in the future. IMDA can also conduct mid-term adjustment in the third year if there are significant changes in cost inputs or demand forecasts due to unforeseen circumstances.

Formula:

Nominal Pre-tax WACC = Cost of equity X (1 – gearing) + Cost of debt X gearing (1 – tax)

Tax Savings

Under the Singapore Income Tax Act, NLT will qualify for qualifying project debt securities (QPDS) because of the S$1.1bn (at 10.5% fixed interest rate p.a.) issue of NLT notes. The interest expense is tax deductible for NLT, interest income received by the trust will be tax exempted. The tax savings will contribute to higher distributions to unitholders.

Distribution

NLT's distribution policy is to distribute at least 90% of its distributable income to the trust. The Trust's distribution policy is to distribute 100% of its Cash Available for Distribution (CAFD). We forecast S$180mn CAFD to unitholders in FY19e. Distribution yield works out to be 5.7% as of current stock price.

Risk factors

Revenue volatility. There are three types of revenue that are relatively more volatile. Firstly, non-residential may face increased competition from RSPs. Secondly, installation-related revenue varies with the number residential, non-residential and NBAP connections. Thirdly, diversion revenue is ad hoc in nature and dependent on property and infrastructure projects. Note these revenues are only approximately 13% of total revenue.

Change in ICO. There will be a review of the average cost of capital WACC of 7% in 2022. Anh downward revision in WACC will impact NLT's regulatory pricing. In our opinion, the current rising interest rate environment will offset any downward pressure on WACC.

Failing to meet the quality of service standards. Potential losses of revenue or fines from IMDA could incur.

Unforeseen CAPEX. Although NLT is required to set aside S$8mn a year for regulatory CAPEX reserve, huge spikes in CAPEX would impact distributions to unitholders.

Investment thesis

1. **Sole network provider of residential fibre broadband in Singapore.** NLT nationwide residential coverage in Singapore accounts for about 60% of its revenue. The asset base of more than S$3bn and the duration needed to build a comparable network across Singapore, will pose a major barrier to entry. Any meaningful return on investment would be a challenge without similar financial assistance from the Singapore government. Under iN2015, NLT received an aggregate grant worth of S$732mn.

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Valuation

NLT resilient business model ensures limited volatility to its sales and its cost base. We used a DCF approach in our valuation because of the regular stream of cash generated from NLT’s fibre business. Our valuation is based on a WACC of 6% and a terminal growth rate of 1%.

Financials

Income Statement

Y/E Mar, SGD '000	FY17	FY18	FY19e	FY20e
Revenue	**299,160**	**228,587**	**357,200**	**392,712**
Operating Profit	80,765	55,416	87,834	107,306
EBITDA	**213,776**	**167,275**	**246,666**	**268,202**
Depreciation & Amortisation	143,319	111,811	158,629	160,379
EBIT	**70,457**	**55,464**	**88,036**	**107,822**
Net Finance Inc/(Exp)	(10,087)	(12,180)	(20,110)	(21,717)
Profit before tax	70,794	43,809	68,891	87,030
Taxation	8,636	6,141	7,639	5,001
Net profit, reported	**79,430**	**49,950**	**76,529**	**92,031**

Per unit data (SGD Cents)

Y/E Mar	FY17	FY18	FY19e	FY20e
EPU, reported	2.0	1.3	2.0	2.4
DPU	2.1	3.2	4.7	5.3
BVPU	78.8	81.5	80.2	77.9

Cash Flow

Y/E Mar, SGD '000	FY17	FY18	FY19e	FY20e
CFO				
Profit before tax	**70,794**	**43,809**	**68,891**	**87,030**
Adjustments	153,245	120,964	177,775	181,171
WC changes	(13,781)	25,075	15,400	(4,786)
Cash generated from ops	210,258	189,848	262,066	263,416
Tax paid	(10,012)	(20,407)	(20,110)	(21,717)
Others	(4,672)	(10,985)	(6,703)	(6,743)
Cashflow from ops	**195,574**	**158,456**	**235,252**	**234,956**
CFI				
CAPEX, net	(117,275)	(212,181)	(75,000)	(70,000)
Others	-	(1,095,044)	-	-
Cashflow from investments	**(117,275)**	**(1,307,225)**	**(75,000)**	**(70,000)**
CFF				
Share issuance, net	-	2,334,718	-	-
Loans, net of repayments	-	(1,019,477)	30,026	49,459
Distributions	(80,000)	-	(126,262)	(182,278)
Others	-	-	-	-
Cashflow from financing	**(80,000)**	**1,315,218**	**(96,236)**	**(132,820)**
Net change in cash	(1,701)	166,449	64,016	32,136
CCE, end	**15,929**	**166,449**	**230,465**	**262,601**

Balance Sheet

Y/E Mar, SGD '000	FY17	FY18	FY19e	FY20e
ASSETS				
PPE	3,059,509	3,210,668	3,127,039	3,036,659
Others	1,098,012	928,249	928,249	928,249
Total non-current assets	**4,157,521**	**4,138,917**	**4,055,288**	**3,964,908**
Accounts receivables	55,532	63,511	71,878	83,827
Cash	15,929	166,449	230,465	262,601
Inventories	5,499	3,889	6,760	7,055
Finance lease receivables	194	208	208	208
Total current assets	**80,082**	**238,133**	**313,387**	**357,767**
Total Assets	**4,237,603**	**4,377,050**	**4,368,675**	**4,322,675**
LIABILITIES				
Accounts payables	87,222	48,374	75,012	82,470
Deferred revenue	2,387	12,485	12,485	12,485
Tax payable	13,159	0.00	0.00	0.00
Total current liabilities	**102,768**	**60,859**	**87,497**	**94,955**
Long term loans	507,604	588,742	618,768	668,226
Deferred tax liabilites	546,603	552,827	537,520	524,852
Total non-current liabilities	**1,064,020**	**1,141,813**	**1,156,532**	**1,193,322**
Total Liabilities	**1,166,788**	**1,202,672**	**1,244,029**	**1,288,277**
Unitholders' funds				
Unitholders' funds	**3,070,815**	**3,174,378**	**3,124,645**	**3,034,399**

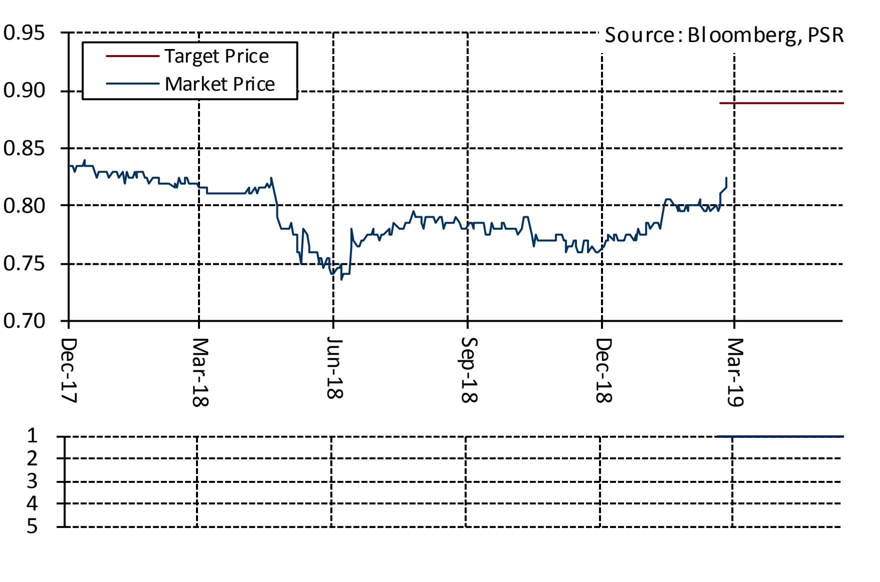
Valuation Ratios

Y/E Mar	FY17	FY18	FY19e	FY20e
P/E (X)	39.7	64.0	42.0	34.9
P/B (X)	1.0	1.0	1.0	1.1
EV/EBITDA (X)	17.1	21.6	14.6	13.5
Growth & Margins				
Growth				
Revenue	-	-23.6%	56.3%	9.9%
EBITDA	-	-21.8%	47.5%	8.7%
EBIT	-	-21.3%	58.7%	22.5%
Net profit, adj.	-	-37.1%	53.2%	20.3%
Margins				
Gross margin	27.0%	24.2%	24.6%	27.3%
EBITDA margin	71.5%	73.2%	69.1%	68.3%
EBIT margin	23.6%	24.3%	24.6%	27.5%
Net profit margin	26.6%	21.9%	21.4%	23.4%
Key Ratios				
ROE (%)	2.6%	1.6%	2.4%	3.0%
ROA (%)	1.9%	1.1%	1.8%	2.1%
Distribution yield (%)	2.5%	4.0%	5.7%	6.4%
Debt/EBITDA (X)	2.3	3.5	2.5	2.5

Source: Company, Phillip Securities Research (Singapore) Estimates

**Forward multiples & yields based on current market price; historical multiples & yields based on historical market price.*

Ratings History



PSR Rating System

Total Returns	Recommendation	Rating
> +20%	Buy	1
+5% to +20%	Accumulate	2
-5% to +5%	Neutral	3
-5% to -20%	Reduce	4
< -20%	Sell	5

Remarks

We do not base our recommendations entirely on the above quantitative return bands. We consider qualitative factors like (but not limited to) a stock's risk reward profile, market sentiment, recent rate of share price appreciation, presence or absence of stock price catalysts, and speculative undertones surrounding the stock, before making our final recommendation

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