TELSTRA INQUIRY

Submission No. 33

Submission to:

The Standing Committee on Communications, Information Technology & The Arts

INQUIRY INTO THE STRUCTURE OF TELSTRA

31 January 2003

SALOMON SMITH BARNEY
A member of citigroup

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BASIS FOR THIS SUBMISSION

Salomon Smith Barney Australia Securities Pty Limited ("SSB"), through its Investment Banking Division, has prepared this paper in response to an invitation from the Secretary for the Standing Committee Inquiry into the structure of Telstra (the "Inquiry") to make a submission, and in accordance with the terms of reference for the Inquiry.

OVERVIEW OF SALOMON SMITH BARNEY

SSB's ultimate parent, Citigroup Inc., is one of the world's leading financial services organisations with a market capitalisation of US$175.8bn (A$299.7bn) and net profit (after tax) of US$15.3bn (A$26.1bn) in the year ended 31 December 2002. It has a global presence, with offices in 102 countries.

SSB is a full service investment bank with strong capabilities in areas such as equities, fixed income, asset management, and the provision of financial advisory and financing services. It has a global team of investment banking professionals dedicated to providing financing and advisory services to the telecommunications sector.

In Australia in 2002, SSB was the top-ranked trader of equity securities (source: Bridge DFS IRESS), the second-ranked adviser on mergers and acquisitions transactions (source: Thomson Financial), and the third-ranked lead manager of equity and equity-linked securities issuance (source: Thomson Financial). In addition, SSB has a team of 7 investment banking professionals specialising in the Australia / New Zealand telecommunications sector.

Additional information on Citigroup is included in the Appendix to this submission.

SCOPE OF THIS SUBMISSION

This submission presents SSB's views on the likely reaction of domestic/international investors to, and hence the market-related valuation implications of, a structural separation of Telstra's core network from its other businesses (together with the reduction of the Commonwealth's current shareholding in Telstra's non-network businesses).

This submission has been prepared by SSB's Investment Banking Division with reference both to the views of SSB employees with equity capital markets expertise and to the views contained in research published by SSB equity research analysts. Given SSB's position as a leading trader and underwriter of equity securities, its highly-ranked equity research capabilities (both in Australia and internationally), and its investment banking advisory expertise in the telecommunications sector, SSB believes it is well-qualified to provide its views on these matters.

We note that SSB's core areas of expertise do not include the other areas cited in the terms of reference, and as such SSB makes no submission in relation to these matters except to comment, in the context of examining potential shareholder value impact, on Telstra's ability to continue to provide a full array of telecommunications services and make ongoing investment in new network infrastructure.

SSB'S APPROACH

In assessing the likely shareholder value implications of separating Telstra's network from its other businesses, SSB has undertaken analysis on the following basis:

- Firstly, SSB has made a qualitative assessment of historical and current investor attitudes to structural separation in the telecommunications sector;

Executive Summary

- Secondly, SSB has assessed the potential impact of a separation of Telstra's core network from its other businesses in the context of key areas of current telecommunications sector investor focus; and
- Thirdly, SSB has examined a range of the most relevant precedent transactions and initiatives undertaken by Telstra's offshore peers in order to draw parallels and assess market reaction. The separation of an integrated operator's network assets from its service provision businesses has been considered by offshore integrated operators but not, to date, undertaken. As a result, there are no direct precedents for assessing the lasting, long-term shareholder value impact of such a separation. British Telecommunications ("BT"), however, did publicly announce its intention to consider such an initiative, and SSB believes that BT's experience is the most relevant precedent for the purposes of this submission, given the direct comparability of the assets being contemplated for separation.

  In the absence of other precedent cases of telecom operators separating (or even announcing an intention to separate) their core networks, SSB has also considered the *de facto* separation that several telecoms have undertaken by progressively carving out, spinning off or selling some of their service businesses (such as mobile, Internet, directories). SSB has provided case studies of five precedent transactions that have been undertaken, although we note that in none of these precedents have there been any changes to the ownership of the core fixed line network.

KEY CONCLUSIONS

On the basis of our analysis of:

- Investor attitudes and the potential qualitative impact of a separation on the key current areas of both domestic and international investor focus in the telecommunications sector; and
- The experience of other operators in considering separation of core network assets and/or non-network assets.

SSB finds little evidence to suggest that, in the prevailing market conditions and based on Telstra's current positioning, any material and sustainable incremental shareholder value would be achieved through the separation of Telstra's core network from the remainder of the business.

The qualitative assessment of the impact of such a separation on shareholder value indicates that, given current market conditions and Telstra's current objectives and requirements, investors are, if anything, likely to respond negatively. This assessment would be unlikely to change unless a compelling commercial rationale / operating model was proposed which supported both Telstra's strategy and the Commonwealth's objectives as major shareholder in Telstra and national policymaker. We note that a model for a separation has not been proposed at this stage.

An assessment of the empirical evidence through precedent transaction analysis provides few conclusions, given the limited number of data points available. This fact in itself can be expected to increase investor caution towards a structural separation proposal.

BT's experience in considering a separation is the most relevant precedent for Telstra. The equity market's reaction to BT's announcement to sell its network was strongly adverse, despite some positive commentary by analysts, but clouded by the fact that the company announced disappointing earnings results concurrently. The initiative was not pursued by BT.

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SSB's view is that it was probably never seriously considered primarily as a shareholder value enhancing initiative.

In examining the experience of Telstra's international peers in separating other, non-network assets, SSB found mixed results. Of the precedents included in the Appendix, only Telefonica could be considered to have had relative success through its strategy of hiving off businesses (directories, wireless, Internet). This success could be argued to have been largely attributable to Telefonica crystallising value for these assets at a time of historically high market valuations. None of the other asset sales and spin-offs considered in the Appendix provide clear evidence of value creation for shareholders.

Qualitative Assessment: Investor Attitudes to Structural Separation

Investor attitudes towards the telecommunications sector have changed significantly during the last four years.

Investor Attitudes – Mid to Late 1990s

At the end of the last decade, investors in the sector were broadly supportive of assets regarded as having strong growth potential, and these assets were able to command premium valuations within the sector which, as a whole, consistently outperformed broader indices in many financial markets.

Wireless and data business units in particular were ascribed premium valuations by investors and a number of international integrated operators undertook separations of these businesses.

In that environment, SSB believes an assessment of the following factors is an appropriate high-level model for considering the potential benefits and risks to shareholder value of a separation of a specific business unit:

Potential Benefits	Potential Risks
▲ Focuses management on single / fewer business units ▲ Creates a new scrip which can be used as acquisition currency for growth / consolidation within specific sector ▲ Means of raising cash at the parent level to reduce debt, fund further infrastructure / licences, or fund expansion of the subsidiary without recourse to shareholders / debt ▲ Potential to unlock value by crystallising higher market valuations for growth assets than could be achieved at the parent level	▼ Execution risk ▼ Loss of synergy benefits between business units (bundling, cross-sell, billing, head office, economies of scale etc.) ▼ Cost of implementation ▼ Use of management resources

Using this model to assess the shareholder value implications of a separation of Telstra leads to the conclusion that the potential risks to valuation outweigh the potential benefits, mainly because only the first two benefits are currently directly relevant to Telstra:

- Telstra is currently modestly leveraged when compared to international peers and does not appear to have an urgent need to raise cash; and
- The potential to unlock 'hidden' value from growth assets (such as Telstra Mobile or Telstra Broadband, Online & Media Services) has diminished over the past two years as investors have become more sceptical of standalone growth assets and valuations have fallen significantly

In addition, investor attitudes have changed over the last four years and SSB believes it is also appropriate to consider the impact a separation would have on the current key areas of focus of investors in the telecom sector.

Qualitative Assessment: Investor Attitudes to Structural Separation

Investor Attitudes – 2002/2003

SSB believes telecom sector investors are currently significantly more cautious than they were in the late 1990s. This is reflected in their key current areas of focus. SSB has considered below the overall likely impact of a separation of Telstra's network from its service provision businesses on each of these areas in order to make a qualitative assessment on the likely shareholder value implications.

Investor reaction to a separation will vary considerably according to the operational model adopted. For the purposes of the analysis below SSB has broadly assumed the following:

- Separation of Telstra into one network business and one service provision business, with the Commonwealth retaining a majority interest in the network business only
- The network business would retain the majority of Telstra's existing service obligations and third party pricing regulations but could sell network services to external service providers. (SSB notes that if structural separation were to occur, the Commonwealth may need to consider owning 100% of the network business. Investors may view that simply maintaining 51% ownership of a separate network business would not fundamentally change any perceived current conflicts between the Commonwealth's role as policymaker and shareholder. SSB has not separately considered the scenario where this would occur).

SSB's views on the impact of separation on Telstra investor sentiment are therefore based on a comparison of investors' appetite for the current Telstra business model with their overall appetite for the two separated businesses. Given that these businesses may attract significantly different types of investor, both to each other, and to existing Telstra investors, this analysis is necessarily high-level.

Investor Focus	Underlying Considerations	Potential Implications of Separation on Telstra Investor Sentiment
Free Cashflow Growth	**Revenues:** ► Investors are now looking for integrated operators to grow free cashflow not solely through revenue growth but also by cost and capital containment, and appropriate balance sheet management. ► Outperformance above market expectations is likely to be supported if revenue growth rates are deemed sustainable. ► 'Bundling' (maximising cross-sale of products and services) has re-emerged as an important business driver for integrated operators.	**Revenues:** *Mixed Impact* ► The network business would continue to have regulated revenues but would develop direct relationships with non-Telstra service providers. The service business may, as a result, have less tightly regulated revenues, although it would remain the most significant service provider in the Australian market. Overall, investors would likely see this as revenue neutral across the two businesses and not dissimilar to the combined impact of the existing Telstra Wholesale business model and the existing regulation. ► Separation within the service businesses would be likely to be seen as a negative on the expectation that cross-selling ('bundling') would become more difficult even though there may be a positive incremental revenue impact from focusing management on single business units. ► To the extent that the competitive position of non-Telstra service providers was strengthened by a structural separation, this would be seen as implying incremental revenue downside for the service businesses.

Qualitative Assessment: Investor Attitudes to Structural Separation

Investor Focus	Underlying Considerations	Potential Implications of Separation on Telstra Investor Sentiment
Free Cashflow Growth	**Costs:** ► In the current lower revenue growth environment, investors are looking to cost reduction as the major engine of cashflow growth.	**Costs:** *Negative Impact* ► A major investor concern is likely to be high implementation costs. A separation will require considerable Telstra management time and the creation of appropriate commercial agreements between the network and service provision businesses. Separation may also imply increased regulatory compliance costs across the separated businesses. ► Certain economies of scale currently shared across the network and service provision businesses are likely to be lost. This negative will be increased considerably if the service provision business is separated further.
Free Cashflow Growth	**Capex:** ► Capex reductions have recently been deployed by integrated operators. Investors are becoming sceptical that further meaningful reductions can be achieved.	**Capex:** *Neutral to Negative Impact* ► Investors would be likely to assume that a separated network business would assume primary capex control with the risk that any capital efficiencies existing between the network and service provision businesses would be lost.
Appropriate Leverage	► High leverage levels and the subsequent emergence of deleveraging plans has been, and continues to be, an important driver of sentiment towards many of Telstra's international peers (particularly European integrated operators). ► *Telstra is currently only modestly leveraged when compared to international peers. The impact of any separation on this factor can, therefore, be expected to have only limited impact on investor sentiment.*	*Mixed Impact* ► Dependent on final transaction structure. ► Given the relative lack of concern about Telstra's current leverage, investors can be expected to look for the most balance sheet efficient use of any cash generated by the transaction.

Qualitative Assessment: Investor Attitudes to Structural Separation

Investor Focus	Underlying Issues	Potential Implications of Separation on Telstra Investor Sentiment
'Safe' Strategic Outlook	▶ Investors are currently not rewarding the prospect of growth in the way they had in recent years. They will only respond positively to delivered and sustainable trends. ▶ Dependable returns and dividend yields have taken on heightened importance and any strategic initiatives must have strong potential for shareholder value enhancement.	*Negative Impact* ▶ Investors are likely to have strong concerns in this area. ▶ A separation of Telstra's network from its service provision business will be radical in the context of the global telecom sector. The lack of a direct precedent can be expected to make investors nervous. ▶ The fact that a separation may appear directly at odds with Telstra's current strategy, and may not be motivated primarily by the desire to drive future growth of the Telstra service provision businesses would also be seen as a negative. ▶ Investors will be likely to perceive that, once completed, such a separation will be very difficult, if not impossible, to reverse should the operating model prove to be unworkable.
Regulatory Certainty	▶ This issue has more visibility in Australia than offshore given the recent passing of the Telecommunications Competition Bill and this Inquiry.	*Negative Impact* ▶ Although it is not possible to establish a direct correlation between Telstra's stock price performance and the recent passing of the Bill, the announcement of the current Inquiry and the debate surrounding separation since the publication of 'Reforming Telstra', a number of equity research analysts currently cite the regulatory environment as a 'risk' to the stock price. ▶ Investors can be expected to assume that separation will result in significantly enhanced short to medium term regulatory uncertainty which would be a negative for shareholder value over that timeframe at least.

CONCLUSION

SSB's qualitative assessment is that the potential risks of structural separation to shareholder value currently seem to outweigh the potential benefits. This assessment is based primarily on current investor themes (and hence likely investor attitudes), and the incremental impact that separation is likely to have on sentiment.

Faced with taking a view on the potential value impact of separation, investors can be expected to attempt to look for precedents to confirm or reinforce their views. SSB believes there are no direct precedents for separation of the core network from the service businesses of an integrated operator and this factor would be likely to add significantly to investor caution.

The following sections of this submission analyse what SSB regards as being some of the most relevant available precedents for the purposes of this Inquiry. However, we note that Telstra's current strategic and financial situation, and (with the exception of BT) the type of separation being considered by this Inquiry, bear limited resemblance to that of the integrated operators that have completed separations in the recent past.

BT: An International Precedent

While other integrated telecom operators may have internally evaluated the merits of creating a network-based company structurally separate from their other businesses, BT is the only operator that has publicly considered such an initiative. SSB believes that BT's experience is the most relevant case study in the context of this Inquiry, as the assets proposed for separation are directly comparable.

While an analysis of BT's experience does not enable an assessment of the long-term valuation impact of separating the network assets (since this strategy was not ultimately pursued), we are able to examine the market's reaction to the announcement and the commentary published at the time by sector experts.

A case study examining the proposed transaction structure and strategic rationale, the market's reaction to the proposal and the eventual strategy pursued by BT is provided below.

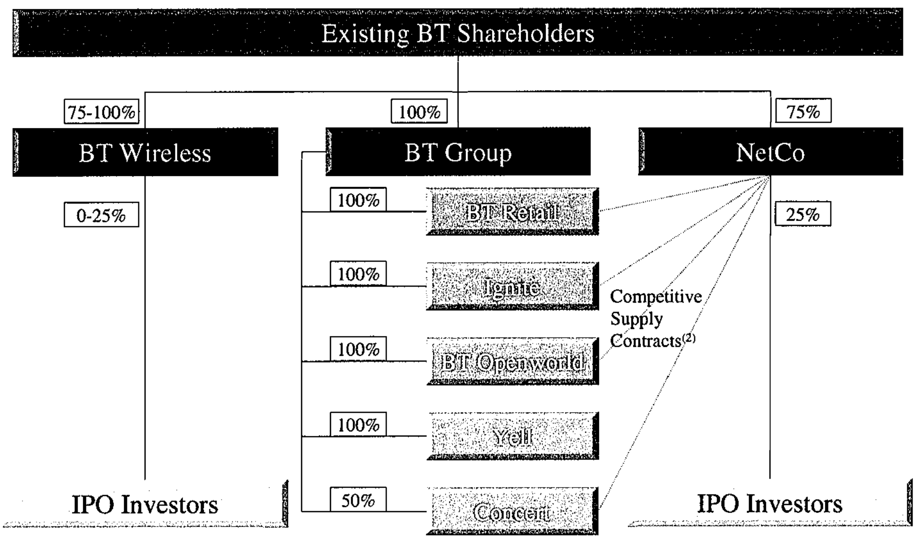
The Proposal

In November 2000, BT announced that it intended to pursue a restructuring plan encompassing the following elements:

- The separation of BT Wholesale [1] into a specialised network-based company ("NetCo"), which would be structurally and managerially distinct from the rest of the company, with an intention to carve out up to 25% of NetCo in an initial public offering;
- The creation of a new holding company ("BT Group") which would house the other business units; and
- The separate listing of up to 25% of BT Wireless, and potentially Ignite (corporate data/Internet) and Yell (directories).

The group structure that would have resulted from such an initiative is depicted below:

Figure 1: Proposed Group Structure post creation of 'NetCo'



(1) BT Wholesale was previously incorporated with BT Retail in the BT Retail & Wholesale division.
(2) BT Retail, Ignite, BT Openworld (mass market Internet business) and Concert (joint venture with AT&T) would be free to purchase capacity from competitors of NetCo.

BT: An International Precedent

Rationale for the Restructuring

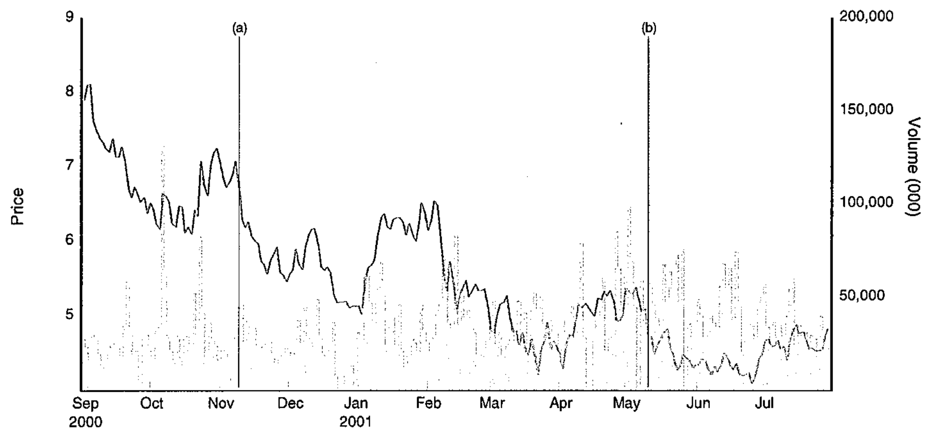
At the time of the restructuring announcement, BT put forward the following rationale supporting the concept:

- Reduction of conflicts of interest between the wholesale unit and other divisions within BT Group (BT Retail, Ignite and BT Openworld):
  - Contracts would have been negotiated on an arm's length basis
  - Other divisions would have been free to purchase capacity from competitors of BT Wholesale
- NetCo would have become a pure utility company paying a solid dividend:
  - Exposure to growth upside would be retained through an expected increase in demand for wholesale voice, data and Internet
  - NetCo's strong cash flow would have enabled it to support a large portion of BT's debt
- BT hoped that there would be an alleviation of regulatory pressure on the retail side of the business, with:
  - NetCo bearing the brunt of any future regulatory pressure, remaining under Oftel's umbrella
  - BT Group being governed only by UK competition law
- Sharpens the strategic direction and focus of NetCo as a standalone entity

Equity Market Reaction

As shown in Figure 2, in the month following BT's announcement, the company's share price fell by 16% (compared to a 6% decline in the MSCI Telecommunications Index and a 3% decline in the FTSE100). However, negative share price performance at the time could have also been attributable to the poor earnings results that were announced by the company concurrently with the restructuring proposal, and as such it is difficult to isolate the impact of the proposal alone on shareholder value.

Figure 2: BT Price / Volume, 1 Sep 2000 – 31 Jul 2001



(a) 11/09/2000: Announcement of Business Restructure
(b) 05/10/2001: Rights Issue / Demerger of BT Wireless Announced

BT: An International Precedent

We note that around the time of the announcement, certain telecom equity research analysts were actually supportive of the NetCo proposal, although acknowledged that the process would be time-consuming and the market would take time to digest the changes.

Sample analyst commentary is provided below (SSB equity research did not publish commentary on the initiative at the time of the announcement):

Deutsche Bank Alex Brown

- The negative response to what we believe is a potentially transformational restructuring initiative at BT is bewildering
- NetCo should be better positioned to leverage the network asset through targeting multiple distribution channels
- The creation of a lean holding company with six largely autonomous operating entities will improve transparency, management accountability and value

ABN AMRO

- The sharpened focus on separate business units and the clarity of the steps BT will take to pay down debt should reassure investors
- The company has now made some difficult decisions and set out the road map it will use to reduce its mounting debt
- To appreciate the potential opportunities that this review facilitates will take time, the bear arguments may win in the short term

Unsolicited Bids for the Network Assets

After having announced it would consider the creation of a separate NetCo, in July 2001 BT received two unsolicited bids for its fixed line network assets:

- German state owned bank Westdeutsche Landesbank made an £18bn offer for BT's fixed line assets;
- Earthlease, a consortium led by Babcock & Brown and Chancery Lane Capital, offered £8bn for the local loop assets only.

Both offers were firmly rejected by BT, on the grounds that the network was a core asset and a sale was unlikely to create value for shareholders. Interest from both bidders nonetheless continued throughout the second half of 2001. SSB believes that BT never seriously considered a sale to either party and the bids were essentially opportunistic.

Eventual Outcome

Ultimately, BT decided not to restructure or divest its network assets. Yell was sold via trade sale in June 2001, BT Wireless (now mmO_2) was demerged from BT via a spin-off in November 2001, and the Concert joint venture with AT&T was unwound in November 2001 (finalised in April 2002). In November 2001, new CEO Ben Verwaayen announced that he was not supportive of the original restructuring proposal, and publicly declared that the network remained a core asset and a core component of BT's strategy.

SSB believes BT's change in strategy was caused by a combination of factors:

- Reducing debt became less of an imperative following the sale of Yell and a rights issue by BT;
- The receipt of unsolicited bids for the assets threatened BT's control over the restructure / sale process;
- Abatement of regulatory pressure from Oftel;
- Continued telecom sector weakness and difficult equity market conditions may have impacted network valuation;
- Logistical and cost obstacles to execution became more apparent; and
- New CEO, Ben Verwaayen was unsupportive of the initiative.

BT: An International Precedent

CONCLUSION

SSB's view is that BT initially proposed the restructuring plan as a somewhat drastic measure to appease both investor concerns about its debt burden and regulatory concerns about wholesale access pricing. We do not believe that the restructure, in its proposed form, was ever seriously viewed by BT shorter term as a value/operation-enhancing initiative, and was predominantly driven by the other circumstances relating to the company at the time.

International Precedents for Separation of Non-Network Assets

A number of the major integrated operators have undertaken separations of other assets over the last five years. While not directly comparable precedents in the context of considering a structural separation of Telstra's core network, they are examples of companies progressively separating (whether wholly or partially) their service-focused businesses to form independent, managerially distinct entities.

A number of these initiatives have been undertaken by European and Asian integrated operators. SSB believes these operators are the most directly comparable of all offshore telecom operators to Telstra. Like Telstra, they typically own long distance and local access networks and offer a range of communications and media services to a very broad, often national, customer base.

Separation has occurred predominantly with regard to three asset classes, being wireless, Internet, and directories. Major examples of recent separations are provided below.

Wireless Assets

Date	Parent	Separated Entity	Action
Nov 2001	British Telecommunications	mmO_2	Spin-off
Jul 2001	AT&T	AT&T Wireless	Spin-off
Feb 2001	France Telecom	Orange	Carve-out
Nov 2000	Telefonica	Telefonica Moviles	Carve-out
Apr 2000	AT&T	AT&T Wireless	Tracking stock
Aug 1999	NTT	NTT DoCoMo	Carve-out
Nov 1998	Sprint	Sprint PCS	Tracking stock
Jul 1995	Telecom Italia	Telecom Italia Mobile	Spin-off

Internet Divisions / Broadband Access Divisions

Date	Parent	Separated Entity	Action
Nov 2002	AT&T	AT&T Broadband	Spin-off
Jul 2000	France Telecom	Wanadoo	Carve-out
Apr 2000	Deutsche Telekom	T-Online	Carve-out
Nov 1999	Telefonica	Terra Networks	Carve-out

Directories Assets

Date	Parent	Separated Entity	Action
Jan 2003	Sprint	Publishing & Advertising	Trade sale
Sep 2002	Bell Canada	ActiMedia	Trade sale
Aug 2002	Qwest	Qwest Dex	Trade sale
Aug 2001	Telenor	Findexa	Trade sale
Jun 2001	British Telecommunications	Yell	Trade sale
Nov 2000	Telefonica	TPI	Carve-out
Jul 2000	France Telecom	Wanadoo	Carve-out
Jan 1997	Telecom Italia	Seat Pagine Gialle	Spin-off

International Precedents for Separation of Non-Network Assets

Although SSB believes that recent European / Asian integrated operator separations are the most relevant precedents to Telstra, we note that a number of US operators have also considered and undertaken less comparable separations in the past:

- In 1984, the establishment of a competitive framework for the telecommunications sector in the US resulted in the creation of separate national long distance and local access operators through the spin-off of the Regional Bell Operating Companies from AT&T. SSB notes there has been no discussion to date of undertaking a transaction involving the separation of the long distance network from the local access network, followed by the regional separation of the local access network, in Australia. As a result we believe shareholder value implications of this transaction have little relevance to this submission.
- Since 1998, both AT&T and Sprint have created tracking stocks. However, these examples are of limited relevance to Telstra because tracking stocks do not necessarily imply underlying structural separation:
  - In November 1998, Sprint shareholders approved the allocation of the assets and liabilities of Sprint into two groups – the FON Group (wireline assets / liabilities) and the PCS Group (wireless assets / liabilities) and created two classes of stock intended to track the financial results and economic value of the two groups. However, shares in FON and PCS do not represent a direct legal interest in the assets / liabilities allocated to the trackers. Sprint continues to own all assets and liabilities
  - In October 2000, AT&T announced its intention to create four separate companies through a combination of tracking stocks and separation of assets:
    - AT&T Wireless was the first of these assets to be spun-off and became an independent company in July 2001, after a tracking stock had been established in April 2000. A case study on this separation is included in the Appendix.
    - AT&T Broadband (which consists of businesses and assets such as pay television and broadband Internet access) was spun off via a merger with Comcast in November 2002
    - AT&T plans to establish an AT&T Consumer tracker stock which is intended to track the performance of the residential long distance voice business

In addition to these examples of operators that have undertaken structural separation, SSB notes also that a number of US policymaking bodies and at least one operator are known to have considered separating network from service provision businesses. This includes the following:

- In 1993, Rochester Telephone filed an 'Open Market Plan' proposal with the New York State Public Service Commission, which included a proposal to open the Rochester local exchange market to competition. In so doing, Rochester created a fully regulated wholesale provider of basic network services and a more lightly regulated service provision business. Both companies remained subsidiaries of the same parent and as there was no underlying asset separation and Rochester had a significantly different market focus to Telstra, SSB believes analysis of shareholder value implications of this experience are of limited relevance to the Inquiry

International Precedents for Separation of Non-Network Assets

- The Public Utilities Commissions of at least two US states have considered structural separation of dominant providers of local telephony services. In 1999, the Public Utilities Commission of Pennsylvania actually ordered Verizon to structurally separate its retail and wholesale units. In 2001, the order was modified to require accounting separation only

CONCLUSION

The Appendix includes five case studies of transactions undertaken by Telstra's international peers that have resulted in the separation of non-network assets from integrated operators.

As noted, these precedents are less relevant than the BT precedent. SSB's view is that the shareholder value impact has been mixed across these precedents. Only in the case of Telefonica could separation potentially be regarded as demonstrating a positive value impact. It could be argued that this was primarily because Telefonica was able to sell off assets at a time when the market values of these assets were at historical premiums, and when scrip created by these separations could be used as an acquisition currency. Both of these benefits are considerably less relevant in current market conditions.

APPENDIX

A. Precedent Separations of Non-Network Assets

Telefonica

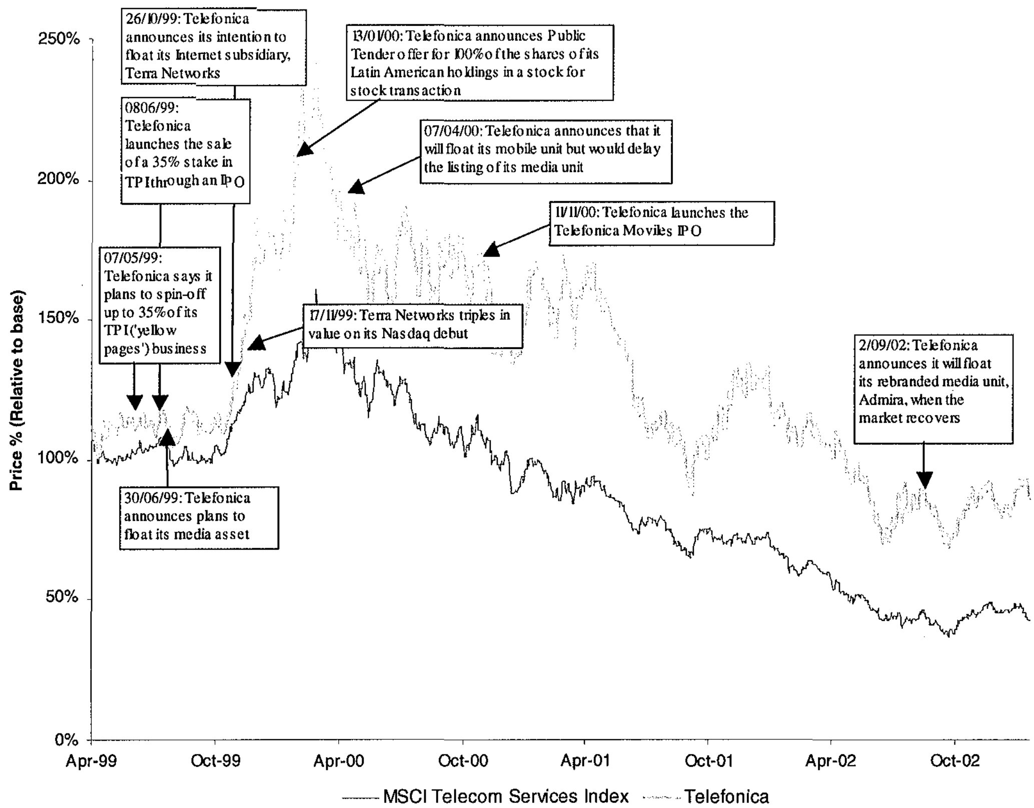
Telefonica achieved considerable value creation throughout 1999 and 2000, at a time when it announced carve-outs of business units, including:

- TPI - its directories business;
- Terra Networks - its Internet business; and
- Telefonica Moviles - its wireless business.

Telefonica also intended to carve out its media business but these plans were shelved in April 2000, during the market correction, when it became clear that the company's valuation expectations would be under pressure. In September 2002, Telefonica announced that these plans would be revisited when market conditions improved.

Over this period, and since, Telefonica's share price has significantly outperformed its international peers, as demonstrated below:

Figure 3: Telefonica Share Price Performance (1 April 1999 to 30 January 2002)



Since 1 April 1999, Telefonica's share price has fallen only 14.1% compared to the global MSCI Telecom Services Index, which is down 57.4%

Telefonica's separation strategy appears to have contributed positively to its long-term shareholder value, although we note the company was able to crystallise value for its separated businesses at a time of historically high market valuations.

The company's share price performance may also have been a result of several other variables, such as superior management, sound financial management, and the underlying operating performance of the business.

Deutsche Telekom / T-Online

Carve-out of T-Online: Transaction Summary

- Deutsche Telekom floated 9% of its Internet service provider, T-Online on 17 April 2000
- T-Online is Europe's largest Internet service provider with 11.9 million subscribers
- Initial indicative range was €35-50 a share valuing the company at up to €55bn
- Following the market correction in March and April along with recent poor performing technology floats, the indicative valuation range was lowered to €26-32 a share on 3 April 2000
- Strong demand for the stock led to the issue being oversubscribed only halfway through the subscription period. One in five Germans reportedly subscribed for the offering
- The offering closed 20 times oversubscribed with strong demand from both institutional and retail investors. The final allocation was 48.2% retail, 51.8% institutional.
- The final price was €27 a share, following the NASDAQ's 9.7% fall the day before the listing
- On the day of listing the shares closed significantly above issue price at €35.2
- Given the adverse market conditions at the time of the offer, the float was seen as a success by the market and returned confidence into the European IPO and technology markets after the NASDAQ correction in April

Figure 4: Share Price Performance 3 Months Either Side of T-Online Listing

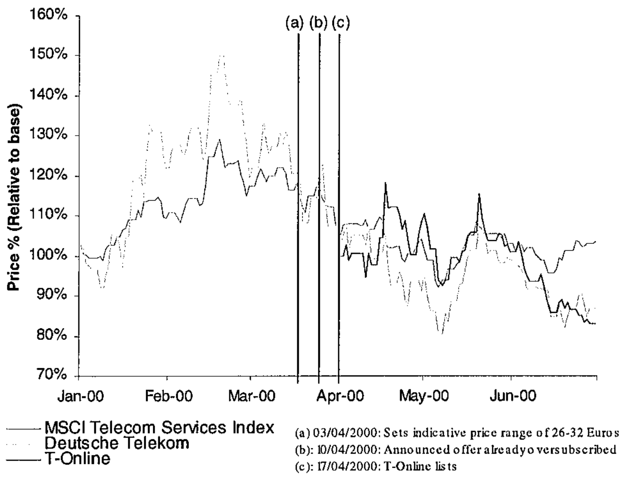
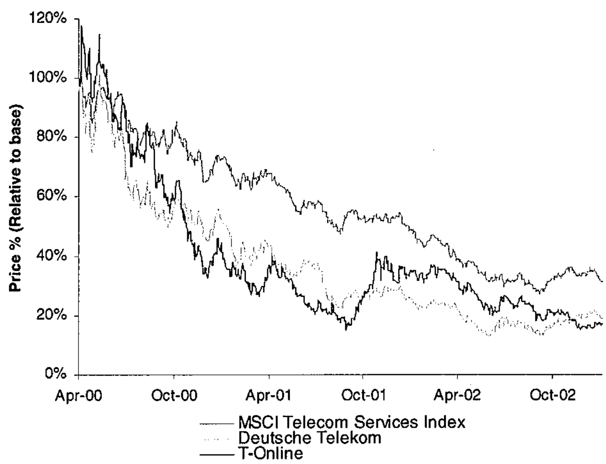


Figure 5: Share Price Performance Since T-Online Listing



In the prevailing difficult market conditions, the initial public offering was seen as a success. However, as yet there has been no evidence to suggest that the separation has enhanced long-term shareholder value.

France Telecom / Wanadoo

Carve-out of Wanadoo: Transaction Summary

- France Telecom floated 9.7% of Wanadoo, France's leading Internet media / directories company
- Rationale for the float was to unlock hidden value in Wanadoo and release further capital to allow other acquisitions without requiring further capital injections from France Telecom
- On 2 March 2000, France Telecom flagged the possibility of the listing, leading to a 25.5% surge in stock price
- On 31 March 2000, the listing of Wanadoo was confirmed for July or September
- The offer opened on 30 June, closing on 13 July with a price range of €17-20. This price range represented a lower than originally expected value due to the market correction of March / April 2000
- Despite the depressed nature of telecommunications and tech stocks, the offer was many times oversubscribed by both institutional and retail investors
- Wanadoo listed on 19 July. France Telecom was able to set the issue price at €19 – close to the top of the indicative price range. This valued Wanadoo at €19bn
- Wanadoo closed up 10% on its first day and 13% after its first week of trading

Figure 6: Share Price Performance 3 Months Either Side of Wanadoo Listing

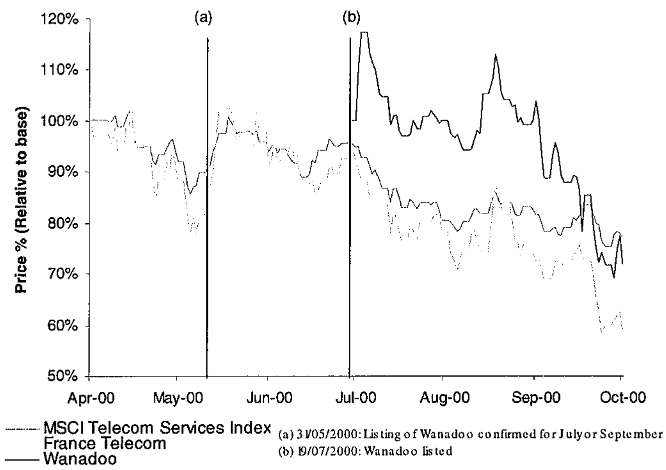
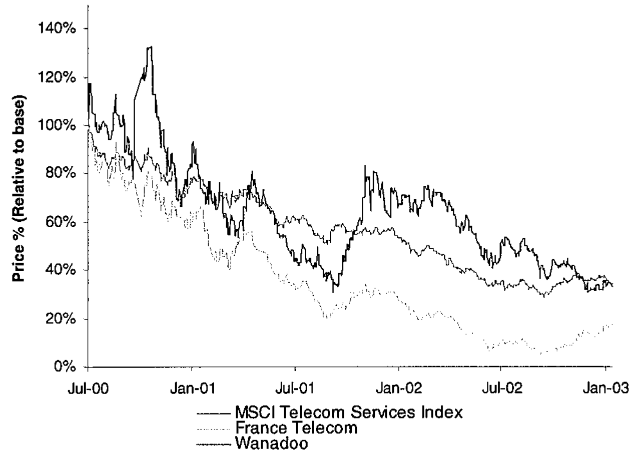


Figure 7: Share Price Performance Since Wanadoo Listing



The immediate post-separation stock price performance was poor with both stocks trading down in the three months following listing. Over the medium to long term, there has been no evidence of lasting shareholder value creation. France Telecom (which also carved out its wireless subsidiary, Orange) has in fact been one of the weakest performing integrated operators globally in the last three years.

British Telecom / mmO_2

Spin-off of mmO_2: Transaction Summary
▶ The demerger of mmO_2 from BT on 9 November 2001 created Europe's 5th largest provider of mobile communications with 16.8 million active mobile customers
▶ Rationale behind the demerger was to release shareholder value while enhancing both BT's and mmO_2's respective positioning in increasingly competitive markets
▶ Created two independent FTSE 100 Companies – mmO_2 and BT Group
▶ Estimated firm value of the transaction was £7.7bn
▶ BT shareholders received one share of mmO_2 plc and one share of BT Group plc for every share in BT
▶ First major European integrated operator to demerge its mobile business
▶ Dual listing on LSE and NYSE, including initial listing of mmO_2
▶ New board of directors and management was instated for mmO_2 and the balance sheet was recapitalised

Figure 8: Share Price Performance 3 Months Either Side of mmO_2 Listing

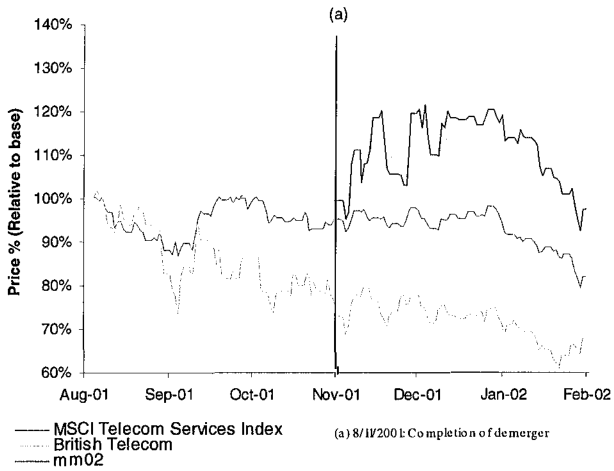
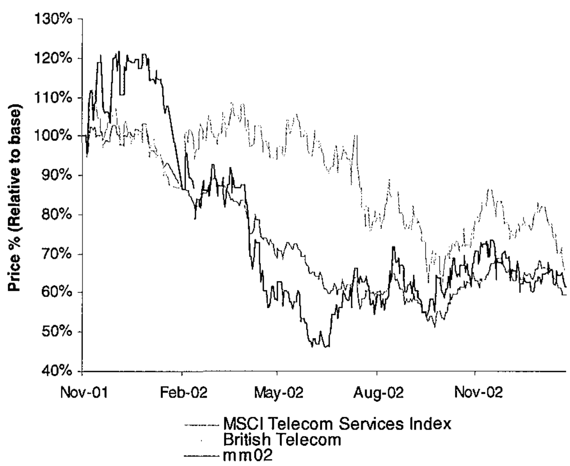


Figure 9: Share Price Performance Since mmO_2 Listing



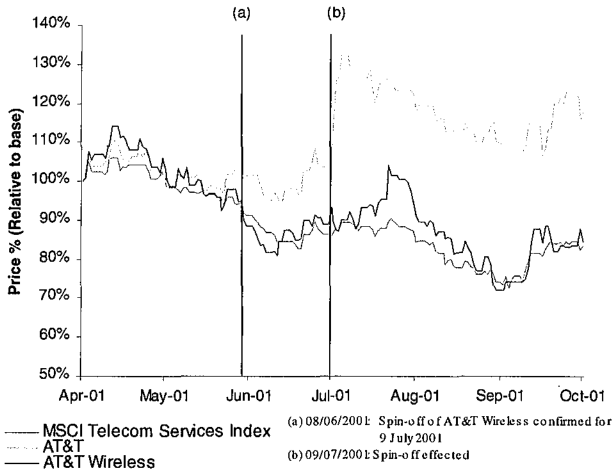
Immediately following the spin-off BT traded down while mmO_2 traded up. Since then, BT's share price has performed marginally above the telecom index while mmO_2 has closely tracked the index. However, there is no compelling evidence to suggest the spin-off in its own right was value enhancing for BT. BT's share price performance is more likely a reflection of investors rewarding the company for overcoming its debt problems, which were previously weighing heavily on the stock price.

AT&T / AT&T Wireless

Spin-off of AT&T Wireless: Transaction Summary

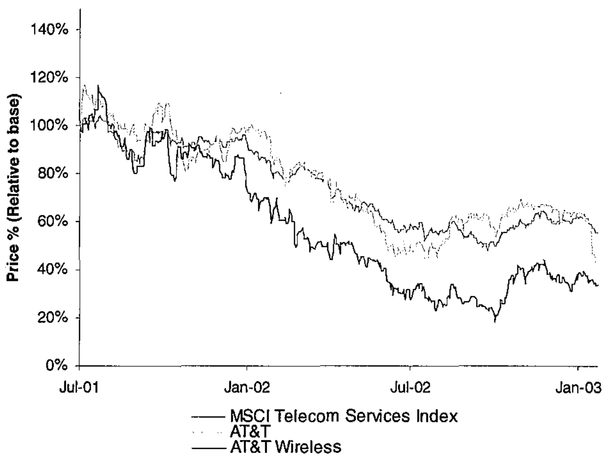
- On 8 June 2001, AT&T announced that it would spin off AT&T Wireless into an independent entity on 9 July, creating the largest independently-traded wireless company in the US with 15.7 million subscribers
- Rationale for the spin-off was to increase AT&T Wireless' operational agility, improve deployment of resources and enhance customer responsiveness
- The spin-off was undertaken by way of redemption of the AT&T Wireless tracking stock already on issue, with the tracking shares exchanged for common shares in AT&T Wireless on a 1-for-1 basis. In addition, existing shareholders of AT&T were issued common shares in AT&T Wireless by way of a special dividend payment of .3218 AT&T Wireless shares for every share held in AT&T
- Following the spin-off, AT&T Wireless was owned 63% by AT&T shareholders and 30% by previous holders of AT&T Wireless tracking stock, while AT&T retained 7%
- AT&T Wireless had a market cap of US$42bn (A$71bn) and US$5bn (A$9bn) of debt following the spin-off
- AT&T Wireless common shares listed on 9 July, and traded down 3.4% on the first day of trading. This was primarily a result of AT&T shareholders disposing of their newly issued AT&T Wireless shares

Figure 10: Share Price Performance 3 Months Either Side of AT&T Wireless Spin-off



Note: AT&T Wireless traded as a tracking stock prior to the spin-off.

Figure 11: Share Price Performance Since AT&T Wireless Spin-off



In the week after the spin-off was effected, AT&T's share price jumped more than 30%. However, this was more likely a result of Comcast announcing a US$44.5bn (A$75.9bn) bid for AT&T Broadband on 8 July 2001. In any event, AT&T's relative share price performance has since fallen below that of the MSCI Telecom Services Index, while AT&T Wireless has lost nearly 70% since the spin-off and is well below the index.

B. Background Information on Citigroup

Background Information on Citigroup

Citigroup is one of the world's leading financial services organisations with a market capitalisation of US$175.8bn (A$299.7bn) and net profit after tax of US$15.3bn (A$26.1bn). It has a global presence, with offices in 102 countries.

The full suite of investment and commercial banking services that are offered by Citigroup (through Citibank and SSB) include:

- Advisory services: mergers and acquisitions, restructurings, trade sales, strategic advisory, privatisations and leveraged buy-outs
- Equity issuance: initial public offerings, secondary offerings, placements, rights issues and structured equity
- Fixed income security issuance: investment grade, high yield, liability management and structured debt
- Bank finance: acquisition finance, syndicated loans and revolvers
- Research: equity research, fixed income research, economic research, quantitative research
- Structured finance: project finance, asset finance and securitisations
- Risk management: foreign exchange and derivative products
- Corporate products: employee stock plans, employee retirement plans, investment and pension consulting, insurance and annuity plans and corporate cash management
- Consumer banking: private banking and insurance products
- Transaction services: cash management, securities services, trade services

SSB is a leading provider of financing services globally. In 2002, SSB was the second-ranked M&A adviser in terms of total global volume of announced transactions (source: SDC) and the second-ranked lead manager of total global equity issuance volume (source: SDC).

In addition, Citigroup globally is a market leader in global syndicated loans. In 2002, Citigroup raised over US$229bn (A$390bn) in financings through global loan syndications.

SSB's expertise extends specifically to the telecommunications sector. Since 1995, in the telecommunications sector alone, SSB has raised:

- **Over US$88bn (A$150bn) in equity and equity-linked financing;**
- **Over US$169bn (A$288bn) of investment grade debt; and**
- **Over US$68bn (A$116bn) of high yield debt.**

SSB has over 90 investment banking professionals dedicated to the telecommunications sector globally.

SALOMON SMITH BARNEY

A member of citigroup

Trevor C. Rowe
Chairman, Investment Banking

31 January 2003

Mr. Paul McMahon
The Secretary,
House Of Representatives Communications, Information Technology and the Arts Committee,
R1, Suite 116
Parliament House
CANBERRA ACT 2600

Dear Mr. McMahon,

INQUIRY INTO THE STRUCTURE OF TELSTRA

Thank you for your letter of 20 December 2002 inviting Salomon Smith Barney to contribute a submission to the above-referenced inquiry.

I am pleased to enclose a paper prepared by Salomon Smith Barney's Investment Banking Division which is today being submitted to the Inquiry by e-mail. A hard copy of this paper has also been couriered to you today.

Yours sincerely,

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