

CitiFirst investment idea



TLSIOL: A Tax Efficient Investment

This note details an investment in TLSIOL over the next 11 months. It shows how TLSIOL is a positively geared investment and will potentially provide a profit to investors even if the price of TLS does not change over the term of the warrant.

It will also analyse the tax effectiveness of investing in TLSIOL prior to June 30 2010.

Telstra has a one year target price of \$4.05 with a Buy Medium Risk rating from the Citi Investment Research and Analysis Team.

Case Study: TLSIOL

Please note this case study is general in nature and does not take in to account specific taxation or personal circumstances. Investors should not rely on the information and should obtain specific advice before investing in this product.

Citi Instalment Code	TLSIOL		
Rollover Date	26 May 2011	TLS dividend ex 23rd August 2010	\$0.14
First Instalment (Initial Payment)	\$1.71	TLS expected dividend ex 21 st Feb 2011*	\$0.14
Final Instalment	\$1.75	TOTAL	\$0.28
TLS Share Price	\$3.29		
Gearing Level	53%		

* Based on Citi Investment Research and Analysis Team dividend assumptions. Dividends are not guaranteed to be paid

TLS is paying a total of \$0.28 in dividends over the next 12 months. Let's look at the difference between the dividend yield on TLS shares and an investment in TLSIOL.

ASX Code	TLS	TLSIOL
Investment Amount	\$50,000	\$50,000
Price	\$3.29	\$1.71
Quantity	15,197	29,240
Dividend Received (\$0.28)*	\$4,255.16	\$8,187.20
Grossed Up Dividend (\$0.40)**	\$6,078.80	\$11,696

* next 2 dividends, based on Citi Investment Research and Analysis Team dividend assumptions and are not guaranteed to be paid.

**assuming fully franked dividends (\$0.28 / 0.7)

As you can see from the above, TLSIOL potentially provides a dividend income of nearly double the dividend income from purchasing the underlying shares outright.

Funding Costs

Now let's look at the Funding Costs of TLSIOL:

To work out the Funding Costs, a simple formula is required;

$$\begin{aligned} \text{Funding Costs} &= \text{Underlying Share Price} - \text{Final Instalment (loan amount)} - \text{First Instalment (initial payment)} \\ &= \$3.29 - \$1.75 - \$1.71 \\ &= - \$0.17 \end{aligned}$$

This means it will cost you \$0.17 in funding should you wish to hold the TLSIOL Citi Instalment to the rollover date. BUT, the dividend you expect to receive over this time is \$0.28 (with a grossed up dividend of \$0.40).

This means that **TLSIOL is a positively geared investment**. Should the TLS share price stay the same between now and the rollover date of May 2011 an investor will make a grossed up income of \$0.28 per instalment.

Taxation Implications - Individuals

In Budget 2010 the Government increased the deductible rate for capital protected borrowings to the RBA Indicator Rate for Standard Variable Housing Loans plus 100 basis points.

As the June deductible rate has not yet been announced, let's use the May 2010 rate for the purposes of this example. The May 2010 deductible rate is 8.40%pa. Therefore of the \$0.17 in funding costs to maturity in TLSIOL, approximately \$0.136 is deductible interest, the remaining \$0.034 goes towards the cost of the capital protection and is added to the cost base.

Let's look at the tax consequences for an investor who is on the highest marginal tax rate of 46.5% and has invested in a TLS Instalment or TLS shares (please note this is for illustrative purposes only) for longer than a year:

ASX Code	TLSIOL
Dividend Income	\$8,187.20
Franking Credits	\$3,508.80
Grossed Up Dividend	\$11,696
Deductible Interest	\$3,968.55 ((quantity * loan amount * deductible rate)/365 * days to maturity)
Tax Benefit of Interest	\$1,845.38 (deductible interest * 46.5%)
Dividend Tax Cost	\$1,929.82 (Grossed up Dividend * 46.5% - Franking Credits)
Tax Benefit of Interest after top-up tax on franked dividends	\$84.45 (Tax Benefit of Interest – Dividend Tax Cost)
Funding Cost	\$4,970 ~ \$0.17 per instalment (10.52%p.a.)
Addition to Cost Base	\$0.034 (((10.52% - 8.40%) * loan per warrant)/365 * days to maturity)
New Cost Base	\$3.324 (original share price of \$3.29 + addition to cost base)
Assumed Sale Price	\$3.29 (assuming TLS underlying share price has not moved)
CGT Tax Benefit	\$233.02 ((\$3.324 - \$3.29) * (46.50% * 50%)) * quantity
Cash Flow	\$3,364.91 (Dividends – Funding Cost + Tax Benefit of interest after top-up tax on franked dividends + CGT Tax Benefit)

Breakeven Share Price Rise (pre CGT)	-\$0.12 (Incoming Cash Flow / Quantity)
Breakeven Share Price (Pre CGT)	\$3.17
Breakeven Share Price Risk (post CGT)	-\$0.15 (-\$0.12 / (1 - 46.5% * 50%))
Post CGT Breakeven Share Price	\$3.14
% Rise is Share Price to Breakeven	-4.56%

**assuming a deductible rate of 8.15% and 580 days to maturity*

As detailed above, an investor will have a post CGT breakeven share price of \$3.14; that is 4.56% below where TLS is trading today.

Self Managed Super Funds

We can also look at the potential tax contribution shelter for Self Managed Super Funds:

ASX Code	TLSIOL
Dividend Income	\$8,187.20
Franking Credits*	\$3,508.80
Grossed Up Dividend	\$11,696
Potential Interest Deductions**	\$3,968.55 ((loan amount * deductible rate) / 365 * days to maturity) * quantity
Taxable Income	\$7,727.45 (grossed up income – interest deduction)
Excess Franking Credits	\$2,349.68 (franking credits – (taxable income * 15%))
Contribution Shelter	\$15,664.55 (excess franking credits / 15%)

** assuming fully franked dividends (\$0.28*0.3/0.7)*

*** assuming a deductible rate of 8.40% and 337 days to maturity*

The excess franking credits can help create a contribution tax shelter for the SMSF Investor. This means **an SMSF can contribute up to \$15,664.55 to the Super Fund without having to pay contributions tax.**

Summary

TLSIOL is a positively geared investment. The underlying share price does not need to appreciate over the life of the Instalment in order for the investor to make a profit.

Notes

The above analysis uses certain assumptions, in particular it assumes dividends are paid over the life of the instalment at the levels implied by Citi Investment Research. There is no guaranteed that this will occur.

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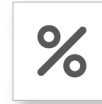
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