

M2 Telecommunications Group Ltd

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Pricing benefits drive upgrade

MTU has upgraded its earnings guidance for FY11 as a result of favourable price reductions in relation to a number of wholesale telecommunications services and the impact of the recent acquisitions of Clear Telecoms and Astar mobile customer contracts. The revised guidance has resulted in FY11 NPAT adj. increasing by 20% (mid-point) to \$30.4m - \$31.9m and EPS adj. increasing by 19% (mid-point) to 24.7 - 26.1cps. On the back of the wholesale price reductions we have lifted our price target and DCF valuation to \$5.15 per share.

Recommendation: BUY
Price: \$3.74
Price Target: \$5.15
Code: MTU

Y/E December		2009A	2010A	2011F	2012F
Revenue	\$m	202.5	406.1	470.4	556.8
EBITDA	\$m	13.1	31.2	51.0	71.1
NPAT - reported	\$m	7.4	16.2	27.4	40.3
NPAT - adjusted*	\$m	8.2	18.5	32.7	45.3
EPS (adj)	CPS	9.7	16.7	26.8	36.8
EPS Growth	%	34.0%	72.7%	60.1%	37.7%
PER	x	38.7	22.4	14.0	10.2
EV/EBITDA	x	31.8	14.6	9.3	6.8
DPS	c	5.5	10.0	17.0	24.0
Yield	%	1.5%	2.7%	4.5%	6.4%

Source: BGF Equities / * Earnings adjusted for non-cash amortisation expense

Wholesale price reductions drive FY11 upgrade

We estimate the ACCC's decision to reduce wholesale prices in relation to a number of fixed line telecommunication services will provide MTU's existing operations with an annualised EBITDA benefit of \$15m. The revised pricing structure is retrospective and effective from 1 January 2011, therefore represents the bulk of the company's upgrade for FY11 earnings.

Guidance reflects a modest impact from acquisitions

We estimate that Clear Telecoms and Astar mobile customer contracts will add approximately \$3m to underlying FY11 EBITDA before the impact of approximately \$2.0m in one-off acquisition costs. For FY12 it is expected that Clear Telecoms and Astar acquisitions will contribute combined EBITDA of at least \$9.5m.

Forecasts upgraded

With our existing forecasts already incorporating the impact of recent acquisitions, we have now incorporated the impact of the wholesale pricing benefits which has resulted in our FY11 and FY12 EPS adj. forecasts increasing by 12.1% and 19.1% respectively. We have also lifted our dividend for FY11 to 17cps (from 15cps) and FY12 to 24cps (from 17cps).

Price target increased to \$5.15 per share (from \$4.10 per share)

On the back of a significant earnings upgrade and associated cashflow benefit from favourable wholesale pricing reductions, we have increased our price target and DCF valuation by 25% to \$5.15 per share (from \$4.10 per share). Our recommendation remains a BUY.

Stock Data

Market Capitalisation \$460.1m
 Issued Capital 122.9m
 Volume (monthly average) 3.1m
 12-month low \$1.36
 12-month high \$4.08

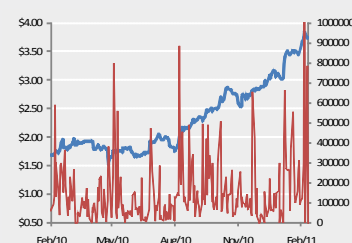
Market Data

Small Ordinaries 2863
 S&P ASX 200 4835
 All Ordinaries 4928

Valuation & Pricing Data

DCF Valuation \$5.15
 EBITDA Multiple \$4.60
 PER \$5.03

Daily Price Chart



Analyst Contacts

Warren Jeffries
warren.jeffries@bgfequities.com
 +61 3 8688 9108

Aaron Muller
aaron.muller@bgfequities.com
 +61 3 8688 9103

Company Guidance – FY11

MTU have upgraded their FY11 guidance on the back of favourable wholesale pricing changes as the ACCC reduces the wholesale rate charged by Telstra on a number of fixed line wholesale services. The guidance also incorporating the impact from recent acquisitions of Clear Telecoms and the mobile customer contracts from Austar.

The revised FY11 guidance reflects reported earnings and as such includes one-off acquisition costs associated with the acquisition of Clear Telecoms which we estimate at \$2m.

Earnings are adjusted to add-back \$3.9m of non-cash amortisation charges associated with customer contracts previously acquired.

Table 1: Earnings Guidance – MTU

(\$m) – unless stated	Previous	Revised	% Δ (midpoint)	Comment
Revenues	425 - 445	450 - 470	5.7	<i>Includes Clear & Austar</i>
EBITDA	41.0 - 42.5	48.5 - 50.0	18.0	<i>Includes acquisition costs for Clear</i>
NPAT	22.0 - 23.5	26.5 - 28.0	19.8	
NPAT (adjusted)	25.2 - 26.7	30.4 - 31.9	20.0	<i>Add back of amortisation - \$3.9m</i>
EPS	18.1 - 19.4	21.6 - 22.8	18.4	
EPS (adjusted)	20.7 - 22.0	24.7 - 26.1	19.0	<i>Add back of amortisation - \$3.9m</i>

Source: MTU Telecommunications Group

Wholesale price reductions material

The ACCC has made an interim determination to reduce prices in relation to a number of fixed line telecommunication services which we estimate will provide MTU with an annualised EBITDA benefit of \$15m. The interim price changes are retrospective and effective from 1 January 2011. A final determination on price reductions is due by 31 December 2011, however we deem any variation to the interim price changes as unlikely.

The price reductions applicable to MTU include:

- Monthly Wholesale Line Rental (WLR) service reducing from \$26.93 (Business line) to \$22.10; and
- Fixed Line local call charges (LCS) charges reducing from 17c to 9.1c per call. *Note: many customers are already receiving an existing pricing closer to the 9.1c per call than the rack rate of 17c per call, therefore a modest benefit is assumed.*

Table 2: Estimated wholesale price reduction benefits

Potential Earnings calculation		Comments
Customers – Fixed line	130,000	<i>MTU had 100k customers as at FY09, acquisitions add 30k</i>
Ave lines per customer	2	<i>BGF estimated average lines per customer</i>
Total customer lines	260,000	<i>Conservative</i>
WLR saving	\$5	<i>\$5 price reduction – before scale, volume discounts</i>
Annualised saving – gross	\$18.7m	
Retention – 75%	\$14.0m	<i>Net WLR saving</i>
LCS reduction	\$1.0m	<i>Modest benefit given discounts already apply</i>
Annualised saving - net	\$15.0m	<i>Estimated gross EBITDA saving for MTU</i>

Source: BGF Equities / Company announcements & ACCC

Background to wholesale pricing changes

In August 2009, the ACCC established pricing principles and indicative prices for fixed line services that expired on 31 December 2010. Subsequently the ACCC has been in the process of consulting with industry on new interim prices which are to apply from 1 January – 31 December 2011, and have determined on a new preferred pricing model.

Given the length of the consultation period, and given that the party most adversely impacted by the pricing change, Telstra (ASX: TLS), has already provided submissions and had consultation with the ACCC prior to the interim pricing reductions, we little reason for the final determination to alter interim prices on the back of any objection by Telstra.

Upgrade to forecasts

EBITDA. Having previously upgraded our forecasts to incorporate the acquisition of Clear Telecoms and Austar's mobile customer contracts, we have now upgraded our FY11 and FY12 forecasts to reflect the impact of the ACCC's wholesale price reductions, which we estimate will add an annualised EBITDA of \$15m.

As a result we have increased our FY11 and FY12 EPS adj. forecasts by 12.1% and 19.1% respectively. We have also increased our dividend assumptions to 17cps (from 15cps) for FY11 and 24 cps (from 17cps) for FY12.

Our FY11 forecasts exclude an estimated \$2m in one-off costs associated with the Clear Telecoms acquisition, while our FY12 forecasts include additional acquisition growth of \$2.5m in new EBITDA, based on MTU acquiring \$5m on annualised EBITDA (effective 1 January 2012) for \$17.5m in cash.

Amortisation of Intangibles. We have reduced the amortisation expense in relation to the acquired customer contracts with FY11 guidance providing visibility on this non-cash expense line for recent acquisitions. We also note that amortisation expense in relation to the previous acquisitions of People Telecom, Commander and Unitel business is expected to cease during FY12.

Table 3: Revised BGF forecasts - underlying

(\$m) – unless stated	FY11			FY12		
	Previous	Revised	% Δ	Previous	Revised	% Δ
EBITDA*	43.5	51.0	17.1	56.1	71.1	26.7
Margins (%)	9.2	10.8		10.0	12.8	
EBITA	40.5	48.0	18.5	53.0	67.1	21.5
Amort of Intangibles	(6.9)	(3.9)	(43.5)	(11.9)	(5.0)	(57.9)
EBIT	33.6	44.1	24.8	41.1	62.1	52.1
NPAT – reported	22.5	28.8	27.8	26.7	40.3	50.8
NPAT - adjusted	29.4	32.7	11.1	38.6	45.3	17.2
EPS reported	18.3	23.6	27.8	21.4	32.8	52.9
EPS adjusted	23.9	26.8	12.1	31.0	36.8	19.1
Dividend (¢)	15.0	17.0	13.3	17.0	24.0	19.6

Source: BGF Equities & Co. announcements / * Excludes \$2m of acquisition costs with Clear Telecoms

FINANCIALS

		Price	\$	3.74
M2 Telecommunications Group		Market Cap	\$	459.5

Year end 30 June

Profit & Loss (\$m)	2009A	2010A	2011F	2012F
Sales Revenue	202.5	406.1	470.4	556.8
EBITDA	13.1	31.2	51.0	71.1
Depn & Amort	1.4	2.6	3.0	4.0
EBITA	11.7	28.5	48.0	67.1
Amort - Identifiable Intangibles	0.8	2.4	3.9	5.0
EBIT	10.9	26.2	44.1	62.1
Net Interest Expense	-0.5	-2.0	-1.3	-2.5
NPBT	10.4	24.2	42.8	59.7
Tax expense	-3.0	-8.0	-14.0	-19.4
NPAT - pre-sign items	7.4	16.2	28.8	40.3
NPAT - adjusted	8.2	18.5	32.7	45.3
Significant items	0.0	0.0	-1.4	0.0
NPAT - reported	7.4	16.2	27.4	40.3

Cash Flow (\$m)	2009A	2010A	2011F	2012F
Operating EBITDA	13.1	31.2	51.0	71.1
- Interest & Tax Paid	3.5	10.0	15.3	21.9
+/- change in Work. Cap.	0.3	-6.2	3.8	1.7
- other	1.5	1.7	4.1	3.2
Operating Cashflow	8.3	13.3	35.4	47.8
- Capex	-0.9	-0.9	-9.0	-8.0
- other	0.0	0.0	-3.1	-3.0
- equity	-9.7	-16.3	-22.2	-22.3
Free Cashflow	-2.4	-3.8	1.1	14.5
- Ord Dividends	-4.3	-8.3	-14.7	-22.1
- Equity /other	0.5	20.4	0.6	0.0
Net Cashflow	-6.2	8.3	-13.0	-7.6
Cash at beginning of period	6.9	6.7	15.1	8.0
+/- borrowings / other	6.0	0.1	6.0	12.0
Cash at end of period	6.7	15.1	8.0	12.4

Balance Sheet	2009A	2010A	2011F	2012F
Cash	6.7	15.1	8.0	12.4
Inventories	1.4	0.3	0.5	0.6
PP&E	5.0	3.7	12.5	19.1
Debtors	49.3	55.8	61.1	71.0
Intangibles	67.2	70.3	88.9	106.6
Other assets	11.7	14.1	14.1	14.1
Total Assets	141.3	159.3	185.2	223.8
Borrowings	16.3	16.6	22.3	34.3
Trade Creditors	55.1	54.2	63.5	75.2
Other Liabilities	21.6	11.5	7.4	4.2
Total Liabilities	92.9	82.3	93.2	113.7
NET ASSETS	48.4	77.0	91.9	110.1

Board of Directors / Substantial Shareholders			
Name	Shareholding	%	
Craig Farrow - Chairman	0.8	0.6%	
Vaughan Bowen - CEO/MD	10.3	8.4%	
Max Bowen - Non-Executive Director	0.0	0.0%	
John Hynd - Non Executive Director	2.8	2.3%	
Michael Simmons - Non-Executive Director	0.0	0.0%	

Substantial Shareholders			
Name	Shareholding	%	
Hunter Hall	13.7	11.1%	
Vaughan Bowen	10.3	8.4%	
Phil Cornish	10.3	8.3%	
National Australia Bank	8.6	7.0%	

Top 20 Shareholders	71.7	57.4%
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Valuation ratios	2009A	2010A	2011F	2012F
EPS (cps) - underlying	8.8	14.6	23.6	32.8
EPS (cps) - adjusted	9.7	16.7	26.8	36.8
PER (x)	38.7	22.4	14.0	10.2
PER Rel - All Ind.	172%	42%	-9%	-22%
PER Rel - Small Ind.	170%	47%	-7%	-18%
Enterprise Value (\$m)	415.2	456.0	473.8	481.4
EV / EBITDA (x)	31.8	14.6	9.3	6.8
EV / EBIT (x)	38.2	17.4	10.7	7.7
DPS (cps)	5.5	10.0	17.0	24.0
Dividend Yield (%)	1.5%	2.7%	4.5%	6.4%
Franking (%)	100%	100%	100%	100%
CFPS (cps)	9.5	11.7	28.4	38.2
P / CFPS (x)	39.3	32.0	13.1	9.8

Profitability ratios	2009A	2010A	2011F	2012F
EBITDA Margin (%)	6.5	7.7	10.8	12.8
EBIT Margin (%)	5.4	6.4	9.4	11.2
ROE (%)	15.2	21.0	31.4	36.7
ROA (%)	8.1	18.1	24.9	29.4
ROIC (%)	21.4	29.9	38.6	45.7

Balance Sheet ratios	2009A	2010A	2011F	2012F
Net Debt (cash)	9.6	1.5	14.3	21.9
Net Gearing (%)	19.8	2.0	15.6	20.0
Interest Cover (x)	28.4	15.7	39.6	28.8
NTA per share (\$)	0.0	0.0	0.0	0.0
Price / NTA (x)	-18.8	6.7	3.0	3.5
EPPOWA (m)	87.4	113.9	124.4	125.0

Growth ratios	2009A	2010A	2011F	2012F
Sales revenue (\$m)	85.8%	100.6%	15.8%	18.4%
EBITDA (\$m)	47.8%	138.3%	63.7%	39.5%
EBIT (\$m)	43.6%	140.4%	68.6%	40.9%
NPAT (\$m)	43.0%	119.0%	78.2%	39.8%
EPS adj. (cps)	34.0%	72.7%	60.1%	37.7%
DPS (cps)	10.0%	81.8%	70.0%	41.2%

Interim Analysis	1H10A	2H10A	1H11F	2H11F
Revenues	187.7	218.4	215.7	254.7
EBITDA	15.3	15.9	20.8	30.2
EBITDA margin (%)	8.1%	7.3%	9.6%	11.9%
EBIT	12.6	13.6	18.1	26.0
EPS (adj)	8.7	9.7	11.4	15.4
DPS	5.0	5.0	7.0	10.0

Valuation		2012F
Normalised EBITDA multiple (x)		
EBITDA (\$m)		71.1
Target EBITDA multiple (x)		8.4
Net Debt (cash) (\$m)		21.9
Implied Valuation		575.5
Per Share		4.60

Target PE Multiple		
EPS (c)		36.8
PER Target (x)		13.6
Per Share		5.03

Discounted Cash Flow		
Cost of equity	13.9% WACC	15.4%
Cost of debt	8.0% Terminal Growth Rate	3.5%
Net Debt/ Net debt + equity	1.9% Per Share	5.15

Disclosure: The author holds securities in M2 Telecommunications Group Ltd

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