ORD MINNETT

Company Review

Ord Minnett Research | Friday, 4 March, 2011

M2 Telecommunications

ACCC Decision Provides Clarity

- M2 Telecommunications (MTU) received the news it had been waiting what seemed like forever for, with the ACCC announcing its decision in relation to Wholesale Access pricing. The result was favourable for MTU, and also better than OM's expectations.
- The ACCC declared yesterday in its first "Interim Access Decision" that the price Telstra can charge business line wholesalers would fall from $26.93 to $22.10, a fall of 22%. OM estimates the net benefit to MTU at the EBITDA line in FY11 will be $6.5m and $10.5m in FY12.
- The ACCC confirmed the decision will be backdated to 1 January 2011, and OM understands that the retail passthrough rate may be lower than originally expected given that:
    - Among MTU Wholesale customers, many have contracts in place until CY12, thus will not get the reduced prices as early as expected, and
    - Within the Retail division, severe price competition is not expected given the largest player in the SMB space, Telstra, is the entity most negatively affected by this decision, and a price war would only dent its margins further.
- Overall, the effect on earnings will be significant, with OM upgrading diluted EPS by 5.6% in FY11 and 8% in FY12, driven by margin improvement given these changes go straight to the bottom line. Our valuation increases by 16% to $4.24 per share and we maintain an Accumulate recommendation. With the ACCC uncertainty clarified, acquisition activity is likely to be the next catalyst.

Key Financials

Year-end June (A$)	FY09A	FY10A	FY11E	FY12E
Revenue ($m)	202.7	406.1	453.9	507.2
EBITDA ($m)	13.3	31.4	49.3	67.0
NPAT ($m)	7.5	16.2	26.7	34.3
EPS (cps)	8.9	14.6	22.0	28.2
P/E	41.2	25.1	16.6	13.0
EV/EDITDA	24.7	13.3	9.5	6.9
Dividend (¢)	5.5	10.0	15.4	19.8
Net Yield (%)	1.5	2.7	4.2	5.4
Franking (%)	100	100	100	100
Normalised NPAT ($m)	8.9	18.6	30.9	39.8
Fully Diluted Norm. EPS (¢)	10.2	16.4	25.4	32.8
EPS Growth (%)	na	59.7	55.6	28.7
Normalised P/E	35.8	22.4	14.4	11.2
Relative P/E (x)	2.2	1.5	1.1	1.0
Normalised ROE (%)	18.4	24.2	36.4	41.8

Source: IRESS, Company, Ord Minnett Estimates. Note: all data as at 3 March 2011.

MTU Last A$3.83

Recommendation
Accumulate (Medium Risk)

Integrated Telecom Services

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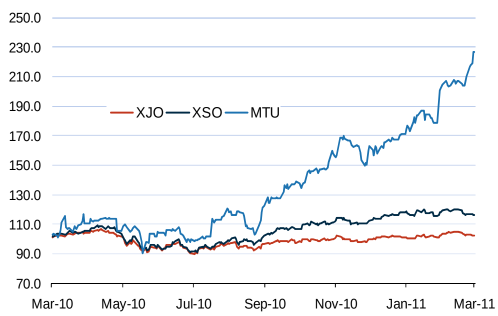
M2 Telecommunications	
ASX Code	MTU
52 week range	A$3.86 - A$ 1.37
Market Cap	A$466 m
Shares Outstanding	121.8m
Av Daily Turnover	A$0.37m
ASX All Ordinaries	4902.8
ASX200 Industrials	3767.3
NTA FY10 (¢ per share)	6.0
Net Debt FY10 ($m)	-1.5

Relative price performance



Source: IRESS

Consensus vs Ord Minnett Earnings

	FY11E	FY12E
NPAT(C)*	-	-
NPAT (OM)	30.9	39.8
EPS (C)*	-	-
EPS (OM)	25.4	32.8

Source: Thomson Financial; Note: One other estimate only.

Financials

M2 Telecommunications **Price:** $3.83 **Recommendation:** Accumulate

Profit & Loss Statement (A$m)	FY09A*	FY10A	FY11E	FY12E
Operating Revenue	202.7	406.1	453.9	507.2
Operating Costs	189.4	374.7	404.6	440.2
Share of Associates	0.0	0.0	0.0	0.0
EBITDA	**13.3**	**31.4**	**49.3**	**67.0**
Depreciation & Amortisation	2.1	5.0	7.1	12.1
EBIT	**11.2**	**26.4**	**42.2**	**54.8**
Net Interest Expense	0.7	2.2	4.0	5.8
Pre-Tax Profit	10.5	24.2	38.2	49.0
Tax Expense	3.0	8.0	11.5	14.7
Reported NPAT	**7.5**	**16.2**	**26.7**	**34.3**
Significant Items (After Tax)	0.0	0.0	0.0	0.0
Normalised NPAT	**8.9**	**18.6**	**30.9**	**39.8**
EBITDA Margin (%)	6.6%	7.7%	10.9%	13.2%
Effective tax Rate (%)	28.9%	33.1%	30.0%	30.0%
Diluted EPS (cps)	**8.9**	**14.6**	**22.0**	**28.2**
Diluted Normalised EPS (cps)	**10.2**	**16.4**	**25.4**	**32.8**
DPS (cps)	5.5	10.0	15.4	19.8
Payout Ratio (%)	62.0%	68.6%	70.0%	70.0%
Franking (%)	100%	100%	100%	100%

Key Statistics	FY09A	FY10A	FY11E	FY12E
Revenue				
Retail	112.4	251.5	293.5	333.9
Revenue Growth		*123.6%*	*16.7%*	*13.8%*
Wholesale	90.3	154.7	160.4	173.3
Revenue Growth		*71.3%*	*3.7%*	*8.0%*
Total Revenue	**202.7**	**406.1**	**453.9**	**507.2**

DuPont Analysis	FY09A	FY10A	FY11E	FY12E
EBIT Margin	5.5%	6.5%	9.3%	10.8%
x Asset Turnover	1.43	2.55	2.38	2.41
x Interest Burden	0.94	0.92	0.91	0.89
x Tax Burden	0.85	0.77	0.81	0.81
= Return on Assets	6.3%	11.7%	16.2%	18.9%
x Leverage	2.9	2.1	2.2	2.2
= Return on Equity	18.4%	24.2%	36.4%	41.8%

Cash Flow Statement (A$m)	FY09A*	FY10A	FY11E	FY12E
EBITDA	13.3	31.4	49.3	67.0
Change in Working Capital	5.7	-7.2	-6.7	-5.4
Net Interest (paid)/received	-0.5	-2.0	-4.0	-5.8
Tax Paid	-2.8	-5.9	-11.5	-14.7
Other Operating Items	0.0	-2.1	0.0	0.0
Operating Cash Flow	**8.3**	**13.3**	**27.1**	**41.0**
Asset Sale Proceeds	0.0	0.0	0.0	0.0
Net Acquisitions	-9.1	-3.8	-20.0	-4.5
Capex	-0.9	-1.8	-9.3	-6.9
Other investing items	-0.6	-11.6	0.0	0.0
Investing Cash Flow	**-10.7**	**-17.1**	**-29.3**	**-11.4**
Inc/(Dec) in Equity	0.5	20.4	0.0	0.0
Inc/(Dec) in Borrow ings	8.0	20.9	20.0	4.5
Dividends Paid	4.3	8.3	18.7	24.0
Other Financing Items	0.0	0.0	0.0	0.0
Financing Cash Flow	**2.2**	**12.2**	**1.3**	**-19.5**
Net Inc/(Dec) in Cash	**-0.2**	**8.4**	**-0.9**	**10.1**

Largest Shareholders	shares (m)	%	Date
Hunter Hall	13.7	11.2%	Dec 09
Vaughan Bow en	10.2	8.4%	Dec 09
Pengana	8.6	7.1%	Dec 09
Dennis Basheer	5.0	4.2%	Dec 09

Per Share Ratios (A$ cents)	FY09A	FY10A	FY11E	FY12E
Normalised EPS	10.2	16.4	25.4	32.8
Dividend Per Share	5.5	10.0	15.4	19.8
Cash Flow Per Share	9.9	12.0	22.3	33.7
NTA per share	-25.8	6.0	4.3	13.6

Valuation Ratios (x)	FY09A	FY10A	FY11E	FY12E
P/E Multiple	37.4	23.4	15.1	11.7
Price To Book Value	-14.8	63.6	88.1	28.1
Price To Cash Flow	38.8	31.9	17.2	11.4
EBITDA Multiple	25.8	13.9	9.9	7.2
EBIT Multiple	28.9	16.4	11.4	8.7

Balance Sheet (A$m)	FY09A*	FY10A	FY11E	FY12E
Cash	6.7	15.1	14.1	24.2
Inventories	2.6	0.3	0.3	0.3
Receivables	50.1	55.8	65.9	76.4
Other Current Assets	2.5	7.3	7.3	7.3
PP & E	5.1	3.7	16.5	16.8
Intangibles	70.3	70.3	79.7	78.7
Other Non Current Assets	4.2	6.8	6.8	6.8
Total Assets	**141.4**	**159.3**	**190.7**	**210.6**
Short term Debt	3.1	5.1	5.1	5.1
Other Current Liabilities	70.4	61.3	64.8	69.8
Long term Debt	13.1	11.4	31.4	35.9
Other Non Current Liabilities	6.2	4.4	4.4	4.4
Non current liabilities	**19.3**	**15.8**	**35.8**	**40.3**
Total Liabilities	**92.9**	**82.3**	**105.7**	**115.3**
Total Equity	**48.5**	**77.0**	**85.0**	**95.3**
Total liability & Shareholder equity	141.4	159.3	190.8	210.6
Net (Debt)/Cash	-9.6	-1.5	-22.5	-16.9

Leverage	FY09A	FY10A	FY11E	FY12E
Net Debt/Equity	19.7%	2.0%	26.4%	17.7%
Net Debt/Total Assets	6.8%	0.9%	11.8%	8.0%
EBIT Interest Cover (x)	15.6	11.8	10.6	9.4

Valuation	A$m	A$		
WACC (%)			11.1%	
Number of shares (m)			121.8	
Cost of Equity			11.5%	
D/EV			10%	
Risk Free Rate			5.50%	
Operational NPV (5 yr Forecast)	158	1.30		
Terminal Value	380	3.12		
Net (Debt) / Cash	10	0.08		
Franking Credits Value	0	0.00		
Group NPV	529	$\boxed{4.24}$		
Current Share Price		3.83		
Relative to NPV:		9.7%	Disc. to NPV	

Source: Ord Minnett estimates, Company data. *Note: FY09 financials have been revised following completion of acquisitions.

ACCC Issue Clarified

The ACCC yesterday released its first Interim Access Determination under revised legislation giving it unilateral power to make access pricing decisions. The key relevant numbers for MTU were a 22% reduction in the Wholesale Line Rental (WLR) rate and a reduction in Local Call Service (LCS) charges from 17c to 9.1c. OM understands that MTU has hundreds of thousands of lines (although the actual number is not disclosed) so the changes announced today are material.

Changes to Earnings

We adjust our estimates to account for margin expansion due to the better than expected ACCC decision. We also increase revenue estimates slightly in FY12 and outer years to accord with our longer term assumption of 7% SMB market share by 2015.

Table 1: Earnings Estimate Changes

	FY11E Old	FY11E New	% variance	FY12E Old	FY12E New	% variance
Revenue ($m)	453.9	453.9	0.0%	498.9	507.2	1.7%
EBITDA ($m)	46.9	49.3	5.0%	62.7	67.0	6.7%
EBIT ($m)	39.8	42.2	5.9%	50.6	54.8	8.3%
Reported NPAT ($m)	25.1	26.7	6.5%	31.4	34.3	9.4%
Normalised NPAT ($m)	29.3	30.9	5.5%	36.9	39.8	7.9%
EBITDA Margin	10.3%	10.9%		12.6%	13.2%	
Fully Diluted EPS (¢)	24.1	25.4	5.6%	30.3	32.8	8.0%

Source: Ord Minnett estimates

Recommendation and Valuation

We **maintain an Accumulate recommendation and increase our valuation to $4.24.** This is due to margin expansion driven by the ACCC decision, and an increase in organic revenue growth rates such that MTU achieve 7% SMB market share by 2015. This assumes that total Small and Medium Business (SMB) revenue stays relatively stable at ~$6b per annum.

Risk Factors

The key risk is renewed competition from Telstra and others. We believe the chances of Telstra becoming more aggressive in this space are low given their stated intentions to focus on retail broadband and mobile.

Fixed to Mobile substitution creates a risk that the key wedge for MTU, fixed line communication, becomes less relevant for small business. Mobile telephony on its own is lower margin than fixed line.

Integration risk becomes a factor when large acquisitions are made, however MTU has experience with acquisitions of similar size and has proven successful.

Regulatory uncertainty also poses risks around pricing agreements with suppliers, leading to an inability to have sufficient visibility on costs. MTU have long relationships with their suppliers and are one of the largest resellers in Australia which helps mitigate this risk to some degree.

General economic weakness would cause businesses to clamp down on costs, which would invariably include telecommunication costs, and likely pressure margins.

BUSINESS DESCRIPTION

Established in 1999, M2 Telecom is a network independent provider of retail fixed-line, mobile and data telecommunications services, specifically tailored towards Small to Medium Businesses (SMBs) in Australia and New Zealand.

The services are primarily sold via the Commander and People Telecom brands, utilising an on-the-ground sales force to deliver a high touch service to customers.

M2 Telecom also acts as a wholesale supplier of telecommunications services to small internet service providers and other smaller resellers.

Please contact your Ord Minnett Adviser for further information on our document.

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Guide to Ord Minnett Recommendations

BUY	The stock's total return (nominal dividend yield plus capital appreciation) is expected to exceed 15% over 12 months.
ACCUMULATE	The stock's total return is expected to be between 5% and 15%. Investors may add to existing holdings, or initiate holdings on share price weakness.
HOLD	The stock is fairly priced, and its total return is expected to be between 0% and 5%.
LIGHTEN	The stock's total return is expected to be less than 0% and possibly down 15%. Investors should consider selling into share price strength.
SELL	The stock's total return is expected to lose 15% or more.
RISK ASSESSMENT	Classified as High, Medium or Low, denotes the relative assessment of an individual stock's risk based on an appraisal of its disclosed financial information, volatility, nature of its operations and other relevant quantitative and qualitative criteria.