StoneBridge

Research Report

Friday, 16 April 2010

SECTOR: INDUSTRIALS

UPDATE

M2 Telecommunications Group Limited | MTU

BUY (PT $2.66)

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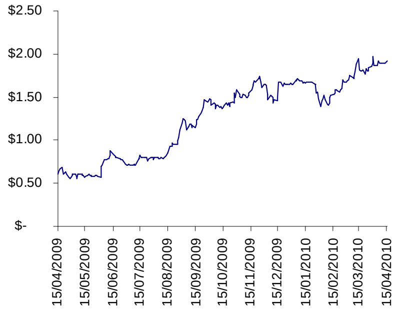
Stock: MTU
Last Price | $1.92
Market cap | $210.8m
52 wk hi/low | $1.97 / $0.56
Fully diluted shares | 110.1m
Target price | $2.66

Share price performance | MTU



Win-Win Acquisition, 1+1 = 3

KEY POINTS

- M2 announced yesterday that it will acquire Clever Communications (CVA)'s off-net fixed, mobile, data and virtual private network customer contracts for $5m in cash, funded out of working capital.
- The payments will be in two tranches, $3.75m payable by 1 May 2010, and the balance 6 months later after successful transfer.
- We believe this acquisition is value-add for the business and given managements' track record, we believe MTU will continue to deliver growth through organic and acquisitive growth.
- We see this acquisition being a logical fit to the business, and at 2.2x EBITDA it is also good value. Hence, we increase our price target for MTU from $2.61 to $2.66 and re-iterate BUY.

IMPLICATIONS

- This is a win-win transaction for both parties in that:
    - MTU bought the business on 2.2x~2.3x FY11 EBITDA based on estimated EBITDA of $2.3m.
    - CVA sold the business that currently generates $0.6-0.8m FY10 EBITDA for $5m cash that it can return to shareholders directly.
- The reasons why MTU can transform a non-performing, non-core business unit in CVA from $0.6m-$0.8m EBITDA to $2.3m by FY11:
    - Better purchasing power: MTU can buy products/minutes at a much more competitive rate than CVA due to its size and negotiation power.
    - Lower direct COGS: lower overheads and same people servicing a bigger customer base.
    - Stronger focus on resale: CVA is primarily a wireless point-to-point internet provider, its management considers the resale business as non-core. Its performance has been tracking backwards. MTU should be able to re-invigorate the business unit with its focus on resale and delivery of customer service.
- This is a logical fit for MTU. The customer contracts comprise of small and medium businesses (SMBs), are complimentary to the current business both in terms of both service delivery and geographic distribution.

- Majority of customers acquired are being supplied business data services, which allows MTU to better utilise its existing network and also having additional field data specialists to compliment its existing channels.
- MTU also signed a wholesale agreement with CVA and can now resell CVA's wireless products to its customers.

DETAILED FINANCIALS

M2 Telecommunications - Summary Financials:

Market Summary:

Share Price:	1.92
Shares on issue:	110.07 mil
Market Cap:	210.78 ($m)
Net Debt (Dec 09)	18 ($m)
EV:	228.78 ($m)

Summary Profit and Loss:	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
Revenue:	33.5	43.8	109.2	202.7	400.0	437.7	470.4	503.4	531.5	553.2
Revenue Growth:		*30.8%*	*149.4%*	*85.6%*	*97.3%*	*9.4%*	*7.5%*	*7.0%*	*5.6%*	*4.1%*
Gross Profit:	10.5	10.8	24.7	36.5	65.5	76.7	82.6	86.3	90.2	92.6
Gross Margin:	*31.4%*	*24.7%*	*22.6%*	*18.0%*	*16.4%*	*17.5%*	*17.6%*	*17.1%*	*17.0%*	*16.7%*
EBITDA	3.7	4.1	9.1	13.3	30.6	39.3	42.5	43.1	44.9	45.1
EBITDA Margin	*10.9%*	*9.3%*	*8.3%*	*6.6%*	*7.6%*	*9.0%*	*9.0%*	*8.6%*	*8.4%*	*8.1%*
NPAT:	2.2	2.4	5.2	7.5	15.4	19.8	21.7	24.0	26.5	26.9
NPAT Margin	*6.5%*	*5.5%*	*4.7%*	*3.7%*	*3.9%*	*4.5%*	*4.6%*	*4.8%*	*5.0%*	*4.9%*

Summary Balance Sheet:

	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
Cash	4.2	2.6	6.9	6.7	1.8	6.4	14.9	23.9	28.5	42.1
Receivables	6.7	7.5	21.3	50.1	58.0	63.5	70.6	75.5	79.7	83.0
Inventory	0.1	0.1	0.3	2.6	0.8	0.9	0.9	1.0	1.1	1.1
Other:	0.5	0.8	1.4	2.5	3.5	3.5	3.5	3.5	3.5	3.5
Total Current Assets	11.4	11.0	29.9	61.9	64.1	74.3	89.8	103.9	112.8	129.6
PP&E	0.5	0.8	1.3	5.1	10.7	12.4	8.6	7.1	6.6	6.5
Other NCA	3.9	9.8	35.7	74.5	70.5	66.8	63.3	60.0	56.9	53.9
Total Non - Current Assets	4.4	10.7	37.0	79.5	81.2	79.2	71.9	67.1	63.4	60.4
Total Assets	15.8	21.7	66.9	141.4	145.3	153.5	161.7	170.9	176.2	190.0
Payables	6.1	11.7	25.7	55.8	56.0	61.3	65.9	70.5	74.4	77.4
Current Borrowings:	0.0	0.1	1.1	3.1	3.1	3.1	3.1	0.0	0.0	0.0
Other CL	1.4	0.5	1.3	14.6	4.1	4.1	4.1	4.1	4.1	4.1
Total Current Liabilities	7.5	12.3	28.1	73.5	63.2	68.5	73.1	74.6	78.5	81.5
Non Current Borrowings:	0.1	0.2	9.1	13.1	21.1	16.1	11.1	9.3	0.0	0.0
Other NCL	0.0	0.0	2.0	6.2	6.2	6.2	6.2	6.2	6.2	6.2
Total Non-Current Liabilities	0.1	0.2	11.1	19.3	27.3	22.3	17.3	15.5	6.2	6.2
Total Liabilities	7.6	12.4	39.3	92.9	90.6	90.9	90.4	90.1	84.7	87.8
Net Assets:	8.2	9.3	27.6	48.5	54.7	62.6	71.3	80.9	91.5	102.3

Summary Cash Flow:	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
Cash Flow from Operations	1.9	3.3	7.3	8.3	4.8	29.1	29.4	31.7	33.2	33.2
Cash Flow from Investing	-1.1	-1.9	-10.2	-10.7	-8.4	-7.6	-3.0	-3.2	-3.4	-3.5
Cash Flow from Financing	-1.3	-2.9	7.1	2.2	-1.3	-16.9	-18.0	-19.4	-25.2	-16.2
Net Movement in Cash:	-0.5	-1.6	4.2	-0.2	-4.9	4.7	8.4	9.0	4.6	13.6
EPS: (cpu)			7.0	8.9	14.0	18.0	19.7	21.8	24.1	24.5
DPS: (cpu)			5.0	5.5	8.4	10.8	11.8	13.1	14.4	14.7
PE Ratio:					13.7	10.7	9.7	8.8	8.0	7.8
PE Ratio (Pre-Amortisation)					11.6	8.2	7.4	7.3	6.9	6.9
EV / EBITDA:			25.1	17.2	7.5	5.8	5.4	5.3	5.1	5.1
Dividend Yield:			2.6%	2.9%	4.4%	5.6%	6.2%	6.8%	7.5%	7.7%

Source: Stonebridge

- Our forecast takes into account of the latest acquisition, with its full effects flowing through from FY11. An increase in revenue and EBITDA compared to previous estimates are direct results of this acquisition.
- DCF valuation of MTU places the stock at $2.66 per share with a 13% weighted average cost of capital.

VALUATION	(5 year DCF:)
Long term gearing:	20.0%
Asset Beta:	1.10
WACC:	13.1%
Forecast Value:	116.4
Residual Value:	189.2
Operating Value:	305.6
Excess Cash:	6.4
Less Debt:	-19.3
Total Value:	292.8
Value per share:	**$ 2.66**

Source: Stonebridge

PEER COMPARISONS

- Compared to its peers, MTU is still on relatively good value given its growth profile, it is currently on 11x FY11 PE, compared to 13x from its peer group (which is mainly dragged up by TPM due to its fibre assets).

Company	Ticker	FYE	MktCap ($m)	# Shares (m)	PE (x)		EPS		EPS Growth		ROE		ROA	
					FY10	FY11	FY10	FY11	FY10	FY11	FY10	FY11	FY10	FY11
M2 TELECOM ^	MTU	Jun	$212	110.1	13.7	10.7	$0.14	$0.18	58%	28%	28.2%	31.6%	10.6%	12.9%
TELSTRA CORP	TLS	Jun	$39,071	12,443.1	9.9	9.7	$0.32	$0.32	4%	2%	30.9%	30.5%	12.3%	12.6%
SINGAP TELEC-CDI	SGT	Mar	$38,716	15,932.5	12.6	11.9	$0.25	$0.26	-5%	6%	17.9%	17.1%	15.7%	15.6%
TELECOM NEW ZEAL	TEL	Jun	$3,191	1,916.8	10.3	11.1	$0.21	$0.20	-18%	-7%	14.7%	13.8%	7.8%	7.8%
IINET LTD	IIN	Jun	$437	151.8	14.0	11.0	$0.21	$0.26	19%	28%	15.2%	16.9%	12.6%	14.3%
AMCOM TELECOM	AMM	Jun	$251	716.9	15.2	10.9	$0.02	$0.03	28%	39%	7.8%	9.9%	8.8%	10.2%
TPG TELECOM LTD	TPM	Jul	$1,750	760.9	23.2	16.1	$0.10	$0.14	268%	44%	19.1%	22.5%	14.0%	18.5%
			$84,942											
Average peer group					**16.1x**	**13.2x**	**$0.16**	**$0.18**	**49.1%**	**17.9%**	**14.7%**	**16.3%**	**10.2%**	**11.8%**
Weighted avg peer group					**11.8x**	**11.1x**								
Median					**14x**	**11.1x**								
ASX200					**16.3x**	**13.2x**								

** All numbers Bloomberg consensus as of 14-Apr-10*
^Data from Stonebridge Group
Note: "-" = No Bloomberg consensus forecasts

Source: Bloomberg, Stonebridge

- Unlike the rest of the listed peer group, MTU is mainly wholesale. Which means other telcos consider it as a customer, not a competitor. MTU's business model is highly suitable in a wholesale only NBN environment, as its current business is wholesale.
- MTU is historically acquisitive and has executed well on its acquisitions, particularly the largest acquisition of Commander assets. This latest acquisition will add to the People Telecom brand under the M2 business and also helps to bolster its data network business.
- We believe future bolt-on acquisitions are still highly probable given the telco space is ripe for acquisitions and MTU is capable of adding significant value to many of its smaller competitors' assets due to its scale and management capability.

RISKS

- As outlined in our previous report. MTU operates in a competitive industry, dominated by the large telco's. It has created a niche in the SME market, by providing a level of service demanded by clients, but not available from large competitors. We believe the M2 business and brand are strong, but note the key risks include:

- *Margin compression:* In a competitive environment, there are limited opportunities to increase price to customers. Margins are maintained and increased by increasing scale and buying power. We do not see margins compression for at least 2 years, given the increase in M2's buying power, and realisation of cost synergies from acquisitions. If M2 are able to increase scale and buying power, margins will likely be maintained.
- *Competition in the SME market:* Through the M2 network, customers receive a level of support not generally available in the market. We note that aggressive price discounting or marketing by competitors could increase competition in the SME market, and attract customers away from the M2 brand. M2 have historically generated very low client churn, which should provide a level of comfort to investors.
- *Network Infrastructure and NBN:* M2 owns minimal telecommunications infrastructure, but acquires products and services from larger telco's. The current view is that NBN will operate independently, as such will provide access to all service providers on an arms length basis. The uncertainty for MTU centres around costs to access the market, and the effect this will have on M2's overall business (wholesale and retail.) We do not see NBN as a short term challenge for the company, and are of the view NBN will increase competition in the telco space, as such this should provide a benefit to MTU.

- Management continues to be very confident of the FY10 guidance. We believe this acquisition is value added to the business, and increase our price target from $2.61 to **$2.66** and re-iterate our **BUY** recommendation**.**

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As at the time of writing this report, the authors did not hold shares in M2 Telecommunications Group Limited (MTU).

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