

## M2 Telecommunications Limited (MTU)

Tuesday, 23 March 2010

SECTOR: Telecommunications Services

**BUY**

### Company Overview

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ASX code | MTU  
Last price | \$1.77  
Fully diluted shares | 110.1m  
Market cap | A\$194.8m  
52 week hi/low | \$1.95 / \$0.48  
12 month price target | \$2.61  
Valuation | \$2.61  
Valuation methodology | 5 year DCF

Share Price Chart | MTU



#### Company Overview:

M2 Telecommunications provides fixed line, mobile and data services to the SME market in Australia and New Zealand, as a reseller of telecommunications services. M2 Telecommunications is the seventh largest telecommunications company in Australia, and the largest "infrastructure lite" telco (minimal infrastructure). M2 operates strong brands such as M2 Telecom, Commander and People Telecom.

#### KEY POINTS

- Telecommunications service provider, servicing the SME space, with a tailored product offering and a business model focused on providing exceptional service to customers.
- M2 has approximately 1% of the telecommunications market share in Australia, and an estimated 3% of the target SME telco market.
- Strong organic growth potential (10-15%pa based on management comments.)
- Acquisition opportunities in the small reseller market, with the potential to immediately increase margins (through cost synergies and increased buying power.)
- Low gearing, with \$18m net debt at December 2009 and strong cashflow.
- Margins to increase in FY2011, as a result of increased buying power, successful integration of acquisitions and an internal focus on operational costs and supplier costs.
- FY2010 management guidance of \$380-400m in Revenue, \$29-31m in EBITDA and EPS of 13.3-14.3 cps (StoneBridge forecasts 14.2cps).

#### COMMENT

M2 management have performed exceptionally well in integrating the recent Commander and People Telecom acquisitions, creating significant value for shareholders.

With increasing margins in the short to medium term, strong organic growth, and potential accretive acquisition opportunities, we see M2 as a quality, well run company, offering attractive returns to shareholders at the current share price.

M2 is trading on a PE multiple of:

12.5 x FY2010 earnings and 9.3 x FY2011 earnings, versus the ASX 300:  
16.0 x FY2010 earnings and 12.6 x FY2011 earnings.

M2 is offering investors a yield of 6.0 % in FY2010 fully franked.

#### INVESTMENT VIEW

With strong growth potential and a solid dividend yield for investors, we see M2 as a buy at the current share price.

**We recommend MTU as a Buy, with a 12 month price target of \$2.61, based on our DCF valuation.**  
(5 year DCF, WACC 13.1%)

Year end Jun	FY08A	FY09A	FY10F	FY11F
Revenue   A\$m	109.2	202.7	400.0	431.1
EBITDA   A\$m	9.1	13.3	30.6	38.8
NPAT (normalised)   A\$m	5.2	7.5	15.6	21.0
EPS (diluted)   cents	7.0	8.9	14.2	19.1
PER (diluted)   x			12.5	9.3
DPS   cents	5.0	5.5	10.6	13.4
Dividend Yield   %			6.0%	7.6%
Franking   %	100%	100%	100%	100%



# 1 Key Investment Features

## STRONG RECURRING REVENUE STREAM WITH ORGANIC GROWTH AND MARGIN EXPANSION

M2 have identified a niche market in the telecommunications market, where exceptional customer support and assistance has resulted in strong organic growth. M2 targets the SME market, offering small business owners a product offering tailored to their needs, with a level of personalised customer support not provided by competitors.

The M2 business represents a recurring revenue stream, which remains in place until a customer terminates a contract, or transfers to a competitor. The average client contract term with M2 is approximately 18 months, but clients in general remain with the company for approximately 5 years. The key to M2's success is a high level of customer satisfaction, creating a low client churn rate.

Management estimate M2 have approximately 3% of the SME telco sector, meaning there is the opportunity to significantly increase market share through organic growth (taking customers from competitors.)

Historically management have supplemented organic growth with targeted acquisitions. In the medium term Management have noted there are a number of small acquisition opportunities in the <\$20m range. Based on historic acquisitions, management have proven they are not prepared to overpay for acquisitions, and therefore it is likely any acquisitions will be immediately accretive.

## VALUATION SUPPORT

M2 is trading at a 26% PE discount to the ASX 300 in FY2011, and a 32% discount to our DCF valuation.

We believe M2 offers investors a solid yield (5.6% in fully franked in FY2010 based on StoneBridge estimates) and strong growth potential through the next few years, as margins increase and M2 continues to take market share.

We view M2 as undervalued at the current price, with a 12 month target price of \$2.61, based on our DCF valuation.

## EXPERIENCED MANAGEMENT TEAM

M2 senior management have created significant value for shareholders since listing in 2004, managing the business through a number of significant acquisitions.

Through the acquisition process, management have managed to retain key staff within both the M2 business, and from the newly acquired businesses, to create an exceptional senior and middle management team.

## KEY INVESTMENT RISKS

M2 operates in a competitive industry, dominated by the large telco's.

M2 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 M2 brand are exceptionally 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 M2 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.



## 2 Business Overview

M2 is a telecommunications service provider, offering fixed line, mobile and internet services to clients, with a focus on the SME sector.

M2's largest brands include Commander, People Telecom, Southern Cross Telco, and M2 Wholesale,

### **Commander:**

M2 acquired the Commander Communications business in June 2009, for 19.0m plus inventory. The acquisition was on a multiple of approximately 1.9x FY2010 EV/EBITDA.

Commander is focused on providing bundled telecommunications services and equipment to small business (target 5 – 100 employees.) Commander is focused on providing customers a suite of products that match a customer's core requirements, while minimising the overall cost to the customer.

The Commander product suite includes all forms of fixed line, data, and mobile services, and telecommunications equipment. Commander is a reseller, and therefore in general does not own the underlying telecommunications infrastructure. The exception is a small amount of data infrastructure, which Commander owns, in order to provide a specific data service to customers.

Commander buys services in the wholesale market, and sells services into the SME market as customised bundles, together with dedicated sales and customer support. The Commander business competes on service rather than price, with a dedicated sales force in place, and in general seeks to acquire customers when their business is moving through a change process (eg moving office location, or growing.)

The Commander sales force only sell Commander products, and operates through dedicated offices, located with a sales region or territory.

### **People Telecom:**

M2 acquired People Telecom in April 2009, for \$19.2m funded mainly through scrip. The acquisition was on a multiple of approximately FY2010 3.2x EV/EBITDA.

People Telecom is the 'challenger' brand in the M2 business, selling bundled products into the SME market. In general People Telecom approaches clients who are not moving through a change process (competing on value rather than service.)

The People Telecom sales force operate as either exclusive or non-exclusive dealers. M2 ensures dealers support the M2 product by providing stability to sales staff (for example by providing a loyalty structure whereby sales staff ensure commission structures are not altered, as long as the sales team remains committed to the People Telecom brand.)



### **Southern Cross Telco:**

M2 acquired Orion Telecommunications, trading as Southern Cross Telco in September 2007 for \$21.8m, cash and scrip, which included the Southern Cross Telco brand. Southern Cross Telco provides regional telecommunications services to homes and small businesses (<10 people.)

Southern Cross is mainly focused on regional customers, including small business and households.

M2 management note the retail market is very competitive, and requires significant marketing spend to gain traction. As a result management are not focused on aggressively growing the Southern Cross business, but will manage customers proactively to maximise value and minimise customer churn.



***M2 Wholesale:***

M2 also provides a wholesale service to small telco's under the M2 Wholesale brand. M2 currently provides wholesale services to approximately 220 small telco clients. Although the wholesale business supports direct competitors to M2's core business, the wholesale unit provides scale to M2's purchase contracts, and therefore assists in reducing cost of using the major carrier's networks, and increases margin for the core retail product offering.

M2's presence in the wholesale market was increased with the acquisition of the wholesale unit from Commander telecommunications in 2008 and niche operator Wholesales Communications Group in 2007.

***Growth Supported by Acquisition:***

M2 has achieved scale through the integration of key acquisitions including Southern Cross Telco, Commander's wholesale unit in 2007, Commanders and People Telecom business assets in 2009.

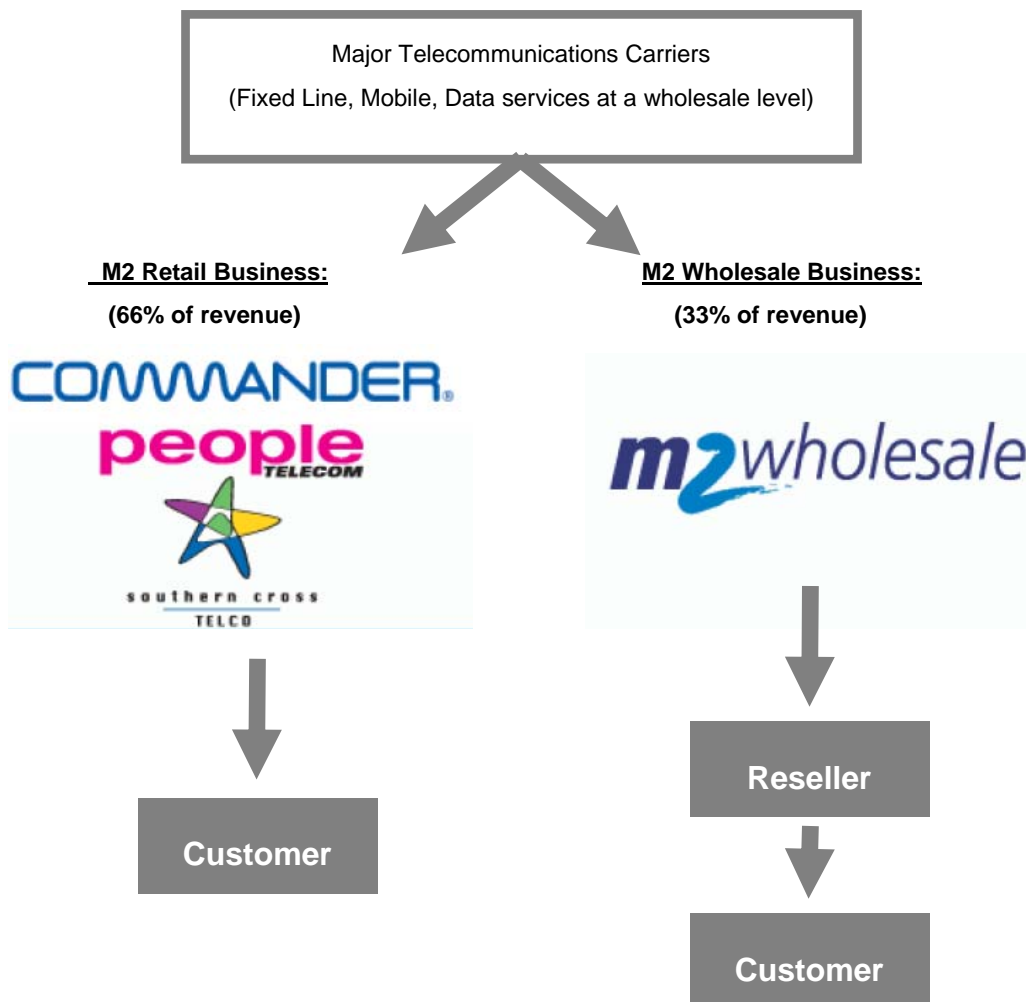
The immediate focus for M2 management following an acquisition is to reduce client churn, to ensure a stable revenue base is in place. In the case of both People Telecom and Commander, management have reduced client churn by at least 50%. With less clients leaving the brand, the revenue base is more stable, and new clients add to revenue, rather than replacing lost clients.



### 3 Financial Analysis

#### KEY REVENUE DRIVERS

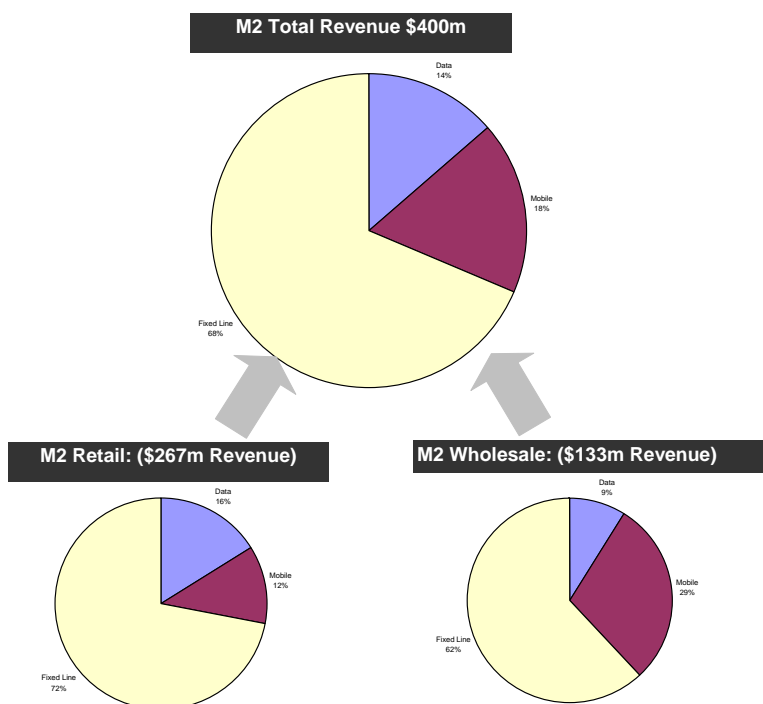
M2 buys telecommunications services at a wholesale level from the major telecommunications providers (Telstra, Optus and to a lesser extent Vodafone) and on-sells these services to M2 customers, generating a margin on the sales.



As M2 scale increases, buying power also increases, providing M2 the opportunity to negotiate a better price from providers.



M2 currently generates the majority of revenue from fixed line services (68% across retail and wholesale,) although data and mobile is increasing as a percentage of revenue.



### COST DRIVERS

M2 Telecommunications is a reseller of services to clients, buying wholesale services from the major telecommunications providers, and selling to customers in the retail market. The key for M2 is minimising the cost of buying services in the wholesale market. Importantly as M2 increases in scale, buying power increases with key suppliers, and M2 is able to increase margins.

M2 note that as a result of increased scale and internal operational efficiencies, margins should increase from FY2011, to approximately 9% EBITDA margins (versus management's internal medium term target of 10%.)

### GROWTH FORECASTS

M2 Revenue is likely to increase by approximately 97% for the full year FY2010, as a result of the full year contribution from the Commander and People Telecom businesses, which were acquired during FY2009, and organic growth in the underlying business. In the absence of acquisition opportunities, M2 relies on organic growth, mainly resulting from new customer acquisition and cross selling of products to customers, rather than price increases.

Cross selling of products to existing customers creates a stickier customer, with an easier sell for sales staff, whereby M2 becomes the trusted adviser to the customer. Examples of current cross selling opportunities include mobile data products and services.

#### **Organic Growth:**

Management estimate Telstra control more than 80% of the SME market, while M2 has approximately 3% of the market. M2 operates in a competitive market, as such few opportunities exist to increase customer pricing, meaning growth is generally a result of new customer acquisition, and the addition of new products. New products create an opportunity to increase revenue from existing customers, without the need to acquire new customers (eg the reduction in mobile internet cost creates an opportunity for the M2 sales force to sell a product into existing customer network which was not necessarily available previously.)



We forecast revenue growth of 7.8% of FY2011 (blended growth between retail and wholesale.)

	<u>2006</u>	<u>2007</u>	<u>2008</u>	<u>2009</u>	<u>2010</u>	<u>2011</u>	<u>2012</u>	<u>2013</u>	<u>2014</u>
Revenue:	33.5	43.8	109.2	202.7	400.0	431.1	463.0	495.2	522.8
Revenue Growth:		30.8%	149.4%	85.6%	97.3%	7.8%	7.4%	7.0%	5.6%

(Source: Company accounts, StoneBridge data)

### **Acquisition Opportunities:**

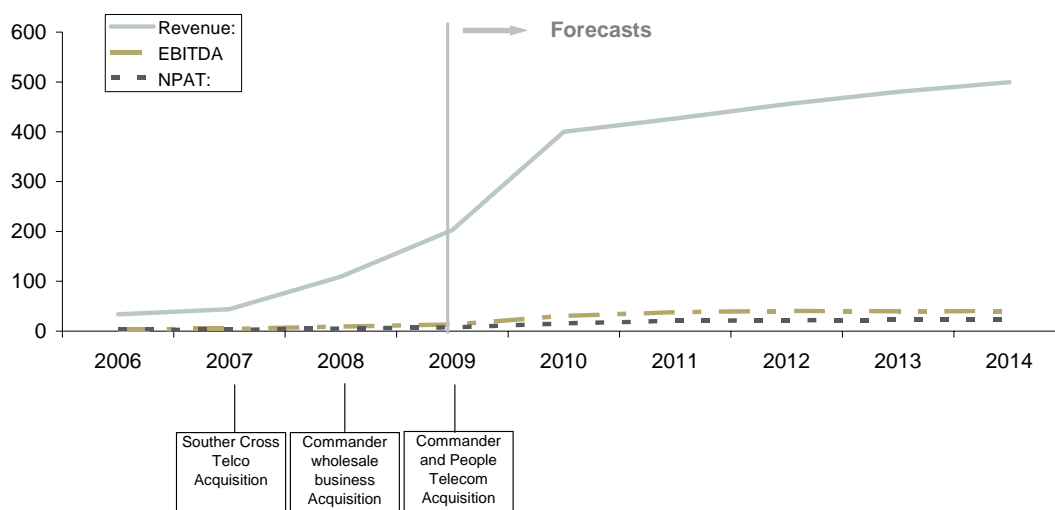
Small service providers and resellers in the telecommunications space require scale to access to reduce their cost of doing business.

Through the acquisition of small operators, M2 can immediately remove corporate overheads, and transition the smaller operators across to M2 supply terms over time, increasing gross margin significantly. Small acquisitions therefore have the ability to add significant value to M2, with gross margins increasing, and contribution adding directly to the bottom line.

### **Financial Forecasts:**

We forecast \$400m in revenue for FY2010, at the top end of management guidance. Through FY2011 and FY2012 we expect to see 10% revenue growth in the retail business, with low single digit growth in the wholesale business.

We expect to see EBITDA margins around 9% in FY2011 and 12.



### **BALANCE SHEET STRENGTH**

At December 2009, M2 Telecommunications held net debt of approximately \$18m (gross debt 23.7m plus cash 5.7m.)

Under the terms of M2 Telecommunications Bank West debt facility, the company is required to amortise \$5m pa, with the most significant covenant being an interest cover test of 5x. M2 is currently well within this covenant (interest cover of 20x based on our forecasts,) and repayment of the debt facility will not be an issue, given the strong cash flow generation of the M2 business.

M2 is carrying \$66m in goodwill and intangibles on balance sheet, a result of historic acquisitions. It is worth noting that for accounting purposes M2 is required to amortise part of the intangible asset (relating to the cost of acquiring customer contracts, which is required to be amortised over 3 years.) Amortisation expense is forecast at \$2.8, in FY2010.



## CAPEX REQUIREMENTS

M2 does not own telecommunications infrastructure, and therefore capex within the M2 business is relatively low. We estimate base capex at \$3m pa.

Over the next 18 months, M2 intends to integrate the central business support system, and is in the final stages of due diligence on a supplier. This business support system is expected to create significant operational efficiencies within the M2 business, creating a payback period of 2-3 years.

The identified provider will assist in integrating a number of internal systems inherited through acquisition, and will provide functions such as billing, reporting, customer relationship management, debtors and revenue leakage (unbilled accounts.)

The presently preferred provider has managed the installation for approximately 40 telecommunications service providers around the world, and operate on a fixed price basis, reducing implementation and operational risk.



## 4 Detailed Financials

### M2 Telecommunications - Summary Financials:

#### Market Summary:

Share Price:	1.77
Shares on issue:	110.07 mil
Market Cap:	194.82 (\$m)
Net Debt (Dec 09)	18.03 (\$m)
EV:	212.85 (\$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	431.1	463.0	495.2	522.8	544.0
			<i>Revenue Growth:</i>							
				30.8%	149.4%	85.6%	97.3%	7.8%	7.4%	7.0%
				5.6%	4.1%					
Gross Profit:	10.5	10.8	24.7	36.5	65.5	75.5	81.1	84.7	88.3	90.7
			<i>Gross Margin:</i>							
				31.4%	24.7%	22.6%	18.0%	16.4%	17.5%	17.1%
				16.9%	16.7%					
EBITDA	3.7	4.1	9.1	13.3	30.6	38.8	41.7	42.3	43.9	44.1
			<i>EBITDA Margin</i>							
				10.9%	9.3%	8.3%	6.6%	7.6%	9.0%	8.5%
				8.4%	8.1%					
NPAT:	2.2	2.4	5.2	7.5	15.6	21.0	22.5	24.1	26.0	26.3
			<i>NPAT Margin</i>							
				6.5%	5.5%	4.7%	3.7%	3.9%	4.9%	4.9%
				5.0%	4.8%					

#### Summary Balance Sheet:

	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
Cash	4.2	2.6	6.9	6.7	0.2	2.5	9.8	15.9	20.5	31.2
Receivables	6.7	7.5	21.3	50.1	58.0	62.5	67.1	71.8	75.8	78.9
Inventory	0.1	0.1	0.3	2.6	0.8	0.9	0.9	1.0	1.0	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	62.5	69.4	81.3	92.2	100.9	114.6
PP&E	0.5	0.8	1.3	5.1	6.9	9.5	7.3	6.5	6.3	6.4
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	77.5	76.3	70.6	66.5	63.2	60.3
Total Assets	15.8	21.7	66.9	141.4	140.0	145.7	151.9	158.6	164.0	174.9
Payables	6.1	11.7	25.7	55.8	56.0	60.4	64.8	69.3	73.2	76.2
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	67.6	72.1	73.4	77.3	80.3
Non Current Borrowings:	0.1	0.2	9.1	13.1	18.1	13.1	8.1	6.3	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	24.3	19.3	14.3	12.5	6.2	6.2
Total Liabilities	7.6	12.4	39.3	92.9	87.6	86.9	86.4	85.9	83.5	86.5
Net Assets:	8.2	9.3	27.6	48.5	52.4	58.7	65.5	72.7	80.5	88.4

#### Summary Cash Flow:

Cash Flow from Operations	1.9	3.3	7.3	8.3	4.9	28.3	31.0	31.2	32.5	32.6
Cash Flow from Investing	-1.1	-1.9	-10.2	-10.7	-4.7	-6.3	-3.0	-3.2	-3.4	-3.5
Cash Flow from Financing	-1.3	-2.9	7.1	2.2	-6.7	-19.7	-20.7	-21.9	-24.5	-18.4
Net Movement in Cash:	-0.5	-1.6	4.2	-0.2	-6.4	2.3	7.2	6.1	4.7	10.6

EPS: (cpu)			7.0	8.9	14.2	19.1	20.4	21.9	23.6	23.9
DPS: (cpu)			5.0	5.5	10.6	13.4	14.3	15.4	16.5	16.8
PE Ratio:					12.5	9.3	8.7	8.1	7.5	7.4
PE Ratio (Pre-Amortisation)					10.6	7.8	7.0	6.9	6.6	6.5
EV / EBITDA:					7.0	5.5	5.1	5.0	4.9	4.8
Dividend Yield:					6.0%	7.6%	8.1%	8.7%	9.3%	9.5%

#### VALUATION

(5 year DCF:)

Long term gearing:	20.0%
Asset Beta:	1.10
WACC:	13.1%
Forecast Value:	115.2
Residual Value:	185.6
Operating Value:	300.8
Excess Cash:	2.5
Less Debt:	-16.3
Total Value:	287.1
Value per share:	\$ 2.61



# Appendix

## Management and Board of Directors

### ***Mr Craig Farrow – Chairman:***

Mr Farrow has been involved with M2 since the original listing in 2004, as non executive director and then chairman. Mr Farrow is founding partner of Brentnalls SA, a chartered accounting firm, and chairman of Tonkin Consulting Engineers. Mr Farrow serves on a number of boards, and is actively involved in the Institute of Chartered Accountants, currently as National Director, Chairman of the Governance Committee and Director of General Practice SA.

### ***Vaughan Bowen – Managing Director:***

Vaughan co-founded M2 in 1999, and has successfully led the business for over 10 years, from a startup company, through ASX listing in 2004, to current the \$200m+ market cap company.

Vaughn was a finalist in the Entrepreneur of the Year – Southern Region in 2004 and 2009.

### ***Max Bowen – Non Executive Director:***

Mr Bowen has in excess of 10 years corporate advisory experience and 20 years commercial property development experience, including experience in financial analysis and business development.

Mr Bowen has previously served as Chairman of M2 Telecommunications Limited.

### ***Mr Dennis Basheer – Executive Director:***

Mr Basheer has served as an executive director in M2 since 2003, and is currently a dealer for the group in South Australia. Mr Basheer has experience in property development, franchise development and project management.

### ***Mr Michael Simmons – Non Executive Director:***

Mr Simmons was appointed to the MTU board in November 2009, with over 10 years experience in the telecommunications industry. Mr Simmons was previously CEO of SP Telemedia Limited and Managing Director of Terria Pty Ltd, a bid syndicate involved in the national broadband network.

### ***Mr John Hynd – Non Executive Director:***

Mr Hynd is a lawyer, and specialist in intellectual property, with a particular focus on technology. Mr Hynd has served as a non-executive director since 2003.

## Substantial Shareholders

Shareholders	Shares	%
Hunter Hall Investments	13,184,021	11.9
Vaughn Bowen – (MD)	10,816,000	9.8
National Australia Bank	8,611,314	7.8



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