


INTERSUISSE

M2 Telecommunications Group (MTU)

Leading SME telco flags 40% FY11 growth after major acquisitions

Recommendation

Strong Buy

Price

\$1.91

Target (within 12 months)

\$2.40

Price/Earnings Ratio FY11E

8.9 times

Franked Yield FY11E

7.8%

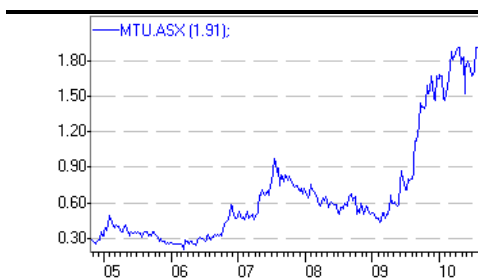
M2 has given guidance of yet another record result for FY10 and earnings growth of around 40% through FY11 as it integrates and builds on its two big acquisitions and subsequent further deals.

- **Strong track record of growth and dividends**
- **A leader in the SME telco field, enjoying margin gains as it works its Commander & People brands**
- **Strong relationships with Telstra and Optus**
- **The largest network independent provider of fixed-line, mobile and data services, with NBN a plus**
- **A 70% franked dividend payout and underpriced.**

Snapshot

Last Price	\$1.91
Market Cap.	\$232 million
52 Week High	\$1.99
52 Week Low	\$0.77
Sector	Telecommunication Services

Price Chart



M2 Telecommunications Group Ltd (MTU) is Australia's largest network independent provider of fixed-line, mobile and data telecommunications services. Established in 1999, M2 is head-quartered in Melbourne and employs approximately 400 people nationwide. M2 also provides fixed-line and 3G mobile services in New Zealand.

See www.m2.com.au & related sites.

Analyst: Peter Russell

Investment Highlights

On 20 July, M2 released earnings guidance for the years ending 30 June 2010 and 2011. The numbers, quoted in ranges, closely matched our previous estimates, with FY11 guidance slightly above and taking account of the recent acquisitions of assets from Clever Communications and Bell Networks.

The implication is that M2 is very much on track and has handled with its customary care and effectiveness the integration of the major acquisitions of People Telecom and Commander a year ago.

Prior to the release of the FY10 results on 30 August, we show here the mid-points of the underlying guidance ranges for FY10 and FY11. We anticipate increasing these estimates slightly after that. We note that the FY11 underlying profit excludes \$3.2m of amortisation of customer contracts that will be a non-cash cost under the statutory accounts. The figures include increased depreciation of IT and system improvements.

M2 is no longer a minnow. It has an institutional backing (it raised \$20m at \$1.80 in May). Its growth has now become predictable in a niche with plenty of opportunity. This is not yet reflected in the price. Buy!

Investment Fundamentals

Year-end June	FY08A	FY09A	FY10E	FY11E
Revenue, \$m	109	203	390	435
EBITDA, \$m	9.1	13.3	30.0	41.8
EBIT, \$m	7.8	11.6	23.9	34.9
NPAT, underlying, \$m	5.4	7.9	15.0	26.0
EPS, underlying, ¢	6.7	9.4	14.0	21.4
EPS Growth, %	67.5	40.3	48.9	52.8
PE Ratio, x	28.5	20.3	13.6	8.9
Dividend, ¢	5.0	5.5	10.0	15.0
Franking, %	100	100	100	100
Dividend Yield, %	2.6	2.9	5.2	7.8

Source: Intersuisse estimates

Company Overview

Bundled telco services for SME's

M2's retail business offers a suite of unique bundled value-add telco services mainly for SMEs through a multi-brand strategy including Commander, People Telecom, Southern Cross Telco and M2 Telecom, each offering unique propositions through dedicated third party dealer channels.

Wholesaler to small telcos and ISP's

"M2 Wholesale" supplies wholesale telco services to small and medium sized telco service providers & Internet Service Providers (ISP's); Australia's largest independent data wholesaler, Wholesale Communications Group, and CDR's network services group, Unitel, were added in 2007 & 2008.

Much expanded business base

In April 2009, M2 completed the acquisition of People Telecom Ltd, followed by the acquisition of the telecoms business assets of Commander Communications Limited, finalised mid-June 2009. Maintaining the core focus of M2, both Commander and People Telecom target the small enterprise market. M2 has a proven track record of delivering consistent growth in both revenues and profit, year-on-year since 2003.

Investment Rationale

MTU's goal is to be the pre-eminent provider of telecoms services to Australian small and medium business. Its growth since listing in October 2004 has proven this is no idle dream. The global financial crisis passed MTU by, and in FY09 it acquired both People Telecom Limited (PEO) and the small and medium business (SMB) assets and related IP of Commander Communications Limited (CDR) late in the period. It also achieved its seventh record year in revenues, profits and dividends, confirming its attraction for serious investors.

FY10 has set a new level of earnings

FY10 was both the biggest opportunity and challenge for MTU. It grew, post acquisitions, to well over 400 staff, with several sets of cultures, management, systems and offices to bed down, coordinate and hone to efficiency. A key focus was to adapt to run the much larger business and build efficiencies in its nationwide complementary SME, retail and wholesale services.

MTU now rates as seventh largest Australian Telco by revenue. Telstra, Optus, Vodafone Hutchison and AAPT, the top four, are followed by TPG Telecom (TPM) (TPG & Soul) and iiNet (IIN), both owning their own infrastructure, next MTU, Primus and Macquarie Telecom, then some 350 smaller resellers and ISPs. The National Broadband Network (NBN) aims to add infrastructure, and will be seeking resellers such as M2.

Several positive events during the last few months

▪ A strong record interim result showed early integration success

M2 had already in the first half overcome the challenge and made an excellent start on the integration and gearing up of its major acquisitions. Numbers were somewhat ahead of our expectations and will improve further in 2H10, despite some further one-off costs, ready for a significant boost, as expected, in FY11.

Strong 1H10 interim - integration on target

\$m	1H10	1H09	% up	\$m	1H10 (U/L)	1H09	% up
Revenue	187.7	87.3	+115%	NPAT	8.19 (9.55)	3.19	+156% / +199%
EBITDA	15.35	6.14	+150%	EPS, ¢	7.5¢ (8.7¢)	4.0¢	+86% / +118%
EBIT	12.68	5.15	+146%	Div, ¢	5.0¢	2.5¢	+100%

The half-year comparison table shows revenue well on target, margin benefits more than expected. Underlying figures ('U/L') are before one-off integration costs; H2 will again outperform. The interim franked dividend was doubled to 5¢.

FY10 guidance was then \$380-400m revenue, \$29-31m EBITDA, \$14.5-15.5m NPAT (\$17.1-18.1m underlying) and 13.3-14.3¢ EPS (15.4-16.4¢ underlying). The release on 20 June confirms this progress, although the underlying earnings are reduced to take account of investments in IT and system improvements and non-cash employee costs.

In March MTU joined the **All Ordinaries Index**

Optus partnership extended

- In April **MTU's status as the officially endorsed aggregator of Optus wholesale 3G post-paid mobile services was extended for a further three and a half years**, to September 2013. The arrangement has enabled a number of small and medium sized telecommunications companies to access wholesale mobile voice and data services on the Optus 3G network. Optus has found this a successful relationship on all levels. M2 Wholesale revenues have grown to over \$130m pa. The extended Optus mobile wholesaling agreement to September 2013 has various new commercial terms which MTU expects will add to competitiveness and flexibility within its 3G mobile voice and data offerings for its core SMB and wholesale markets. Optus has subsequently announced an increased push into the mobile field, a plus for MTU.

Acquires Clover's SME assets

- Also in April, MTU agreed to **acquire selected business assets of Clever Communications Australia Limited** ("Clever", ASX: CVA): Clever's off-net fixed, mobile, data and virtual private network customer contracts with small and medium businesses, together with property, plant and equipment of Clever required to service the acquired customers, and take on relevant Clever dealer and agent relationships. M2 will use the "Clever" brand in the transition and access Clever's business-grade wireless data service, retained by Clever. The deal completed on 3 May with a cash payment of \$3.75m and a further \$1.25m due in six months, subject to performance adjustments. M2 expected the acquisition to deliver a minimum extra annualised EBITDA of \$2.3m, a purchase multiple of 2.2 times EBITDA.

\$20m placement

- On 4 May, **MTU completed an oversubscribed placement** to institutional shareholders and sophisticated investors, raising \$20m. In the first capital raising since listing, the shares were priced at \$1.80, a 2¢ premium on the prior night's close. The proceeds provide additional financial capacity to pursue further acquisitions of complementary businesses and customer bases, particularly in the SME market. The issue expanded MTU's institutional shareholder base with both its existing and several new institutions participating.

Acquiring Bell Networks' SME assets

- On 15 June, MTU agreed to **acquire the small and medium business customer contracts and related business assets of Bell Networks Voice & Data Pty Ltd** ("Bell Networks"). The base consideration is \$4.015m (less certain adjustments) in upfront and deferred cash payments, subject to performance conditions and with a bonus based on 12-month performance. The assets will contribute some \$13m annual recurring revenue and are expected to deliver over \$2m EBITDA annually, a purchase multiple of approximately two times EBITDA. Completion is due on 1 August 2010. MTU said that the planned integration of the Clever assets was progressing well.

- As noted on page 1, MTU on 20 July issued "**strong earnings growth guidance for full year 2011**", including the key table below:

\$m	FY2010(f)	FY2011(f)	% change*
Revenue	380 - 400	425 - 445	Up 12%
EBITDA	29.0 - 31.0	41.0 - 42.5	Up 39%
NPAT	14.5 - 15.5	22.0 - 23.5	Up 52%
NPAT (underlying)	17.7 - 18.7	25.2 - 26.7	Up 43%
EPS (cents)	13.3 - 14.3	18.1 - 19.4	Up 36%
EPS (cents, underlying)	14.5 - 15.5	20.7 - 22.0	Up 42%

* from mid-point of ranges

Strong Earnings Guidance

Our EPS estimates had been 14.0¢ for FY10 and 21.0¢ for FY11, before allowing for the upside from the May and June acquisitions of assets of Bell Networks and Clever Communications, estimated to be neutral in FY10 and add to EPS in FY11 after allowing for the \$20m share placement at \$1.80 in May. We expected franked dividends of no less than 10¢ and 15¢ for these years (a 5¢ interim was paid in March).

Significant customer of Telstra and Optus**The Industry Position of M2**

The group is amongst the largest customers of both Telstra and Optus. It has excellent relationships with both. Commander's long-term landline-focused Telstra connections beefed up those of MTU and more than balanced the latter's mobile wholesaler role with Optus. The nationwide exclusive dealership network of Commander is a great asset alongside the national channels which deliver the service-oriented People Telecom offering, M2 Telecom, Southern Cross and Simply Mobiles (via online).

Full product range and national coverage make M2 a good potential customer for NBN

MTU has a full product range and well-established nationwide coverage. It has a clear strategy to work it and build it. We believe that a positive resolution of the national Broadband Network plans and the entry of NBN into the field of wholesale network infrastructure providers would be beneficial to MTU, both by increasing the network availability to be 'resold' by customer-focused groups like MTU (NBN will be a wholesaler only and MTU is a leading servicer of SME's) and also by resolving the uncertainty that has hung over the industry and releasing pent-up capital expenditure and expansion plans.

We understand that MTU has lower than industry average churn, although it is aiming to reduce it. Substantially all its revenues can be considered recurring income, save for subsidiary Simply Mobiles which sells online discounted handsets. TPG Telecom and iiNet are other significant second-tier players (both interested in AAPT!) in a market likely to see consolidation. However, it appears likely that these would rarely be competing with MTU for acquisitions, given TPM and IIN have their own infrastructure and IIN, whilst growing rapidly, is more focused on Retail & ISPs, MTU on Business & Voice.

Impact and Prospects

Despite being a leader in its niche market, MTU has a market share of around 1%. Its focus on small & medium enterprises (SME) targets a sector serviced by Telstra mainly by default, as major telcos aim at the larger corporations, larger SMEs and residential customers, apart from a focus on government and public sector clients.

With sound finances, strong growth should continue from the newly established earnings base

As MTU's expanded machine slips into higher gear, with enhanced buying and other efficiencies, as well as its substantially larger dedicated sales channels and well-known brands, we expect strong growth in revenues and margins to continue in the foreseeable future. A sub-33% net debt to equity and over 12 times interest cover allows MTU to continue – as we have already seen - bolt-on acquisitions after its self-imposed six-month pause to digest the People and Commander acquisitions. We expect M2 to exceed our estimates and the company's guidance.

Recommendation Impact

M2 is an easy to recommend Buy, particularly for sound growth in a volatile market

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