

## M2 Telecommunications Group Ltd

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### Clear acquisition strategy drives growth

M2 Telecommunications Group (MTU) has acquired Clear Telecoms which is Australia's largest privately owned telecommunications provider. The transaction represents a significant acquisition for MTU with consideration being \$24.5m in cash representing an acquisition multiple of 3.1x forecast EBITDA. The transaction is effective from 1 February 2011 and we have increased our FY11 and FY12 EPS forecasts by 4.9% and 10.7% respectively and our DCF valuation increases by 15% to \$3.70 per share.

Y/E December		2009A	2010A	2011F	2012F
Revenue	\$m	202.5	406.1	473.4	552.3
EBITDA	\$m	13.1	31.2	45.0	55.1
Reported NPAT	\$m	7.4	16.2	20.8	25.7
Normalised NPAT	\$m	8.2	18.5	29.1	37.3
EPS (adj)	CPS	9.7	16.7	23.7	30.0
EPS Growth	%	34.0%	72.7%	41.6%	26.6%
PER	x	33.8	19.6	13.8	10.9
EV/EBITDA	x	27.9	12.8	6.4	4.5
DPS	c	5.5	10.0	5.0	6.0
Yield	%	1.7%	3.1%	4.1%	5.4%

Source: Company Data and BGF Equities

#### Acquisition of Clear Telecoms

MTU will pay \$24.5m in cash for Clear Telecoms (Clear) with approximately 80% of the consideration paid and the balance due over two equal payments in September 2011 and March 2012 and subject to performance criteria. Consideration for the transaction will be funded from existing debt facilities, resulting in net gearing of approximately 20%.

#### Quality business with upside

Clear has approximately 20,000 SME customers generating revenues and EBITDA of \$70m and \$8m respectively which represents high end industry margins of 10%+. Additionally we understand that significant cross-sell opportunities exist for MTU given Clear's client base is under represented in the areas of mobile and broadband compared to that of MTU's typical customer.

#### Earnings upgraded

We have increased our adjusted FY11 & FY12 EPS forecasts by 4.9% and 10.7% respectively based on the Clear acquisition (effective 1 Feb. 2011) delivering annualised EBITDA of \$8m, which is above our FY11 acquisition forecasts for annualised EBITDA of \$5m (effective 1 Jan. 2011). We have forecast further acquisition growth of \$5m in annualised EBITDA for FY12.

#### Recommendation and valuation

We retain our buy recommendation with our DCF valuation and price target increasing by 15% to \$3.70 per share. We see significant potential for further upside to our forecasts from cross selling opportunities to Clear's client base, continued industry consolidation and a favorable ACCC ruling to reduce the price of regulated fixed line telecommunications services that itself could add 75cps to our valuation.

### BUY

Price: \$3.27

Code: MTU

#### Stock Data

Market Capitalisation	\$402.9m
Issued Capital	122.8m
Volume (monthly average)	2.9m
12-month low	\$1.36
12-month high	\$3.35

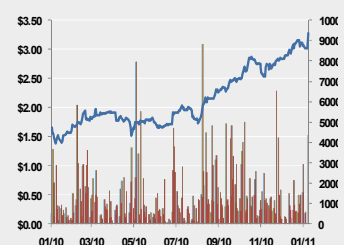
#### Market Data

Small Ordinaries	2842
S&P ASX 200	4752
All Ordinaries	4852

#### Valuation & Pricing Data

DCF Valuation	\$3.70
EBITDA Multiple	\$2.55
PER	\$3.31

#### Daily Price Chart



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## Acquisition of Clear Telecoms

- MTU has announced the acquisition of Clear Telecoms (Clear) which is Australia's largest privately owned provider of business telecommunication services with a customer base of approximately 20,000 SME's nationally.
- The acquisition of Clear will enhance MTU's already strong retail penetration and is highly complementary to MTU's existing brands which include Commander, People Telecom, M2 telecom and Southern Cross Telco.
- MTU will pay \$24.5m in cash for Clear Telecoms (Clear) with approximately 80% of the consideration paid and the balance over two equal payments in September 2011 and March 2012 and subject to certain performance criteria. The transaction will result in MTU carrying net debt of approximately \$20m, representing net gearing of circa 20%.
- We note that consideration for Clear excludes any escalation payments that may result from favorable regulatory changes currently flagged by the ACCC to reduce the price of regulated fixed line telecommunications services that are currently used by communications companies to provide voice, facsimile and broadband products to consumers and businesses over Telstra's copper network.
- In addition to being acquired on a highly accretive acquisition multiple of 3.1x EBITDA, we see significant cross-sell opportunities for MTU given Clear's client base is under represented in the areas of mobile and broadband business to that of MTU's typical customer.
- Integration risk appears minimal given all management and staff (circa 50) will look be retained by MTU. We understand Clear's major shareholder and CEO, Tony Hakim, will not be continuing in his role as CEO.

## Earnings & valuation upgrade

- We have upgraded our earnings forecasts to reflect the acquisition of Clear Communications. Our revisions are outlined below.

Forecast Changes (\$M)	FY11			FY12		
	Old	New	% Δ	Old	New	% Δ
Revenue	469.9	473.4	1.0	541.6	552.3	2.0
<b>EBITDA (\$m)</b>	<b>44.0</b>	<b>45.0</b>	<b>2.2</b>	<b>52.6</b>	<b>55.1</b>	<b>4.8</b>
Depn & Amortisation	3.6	3.7	2.5	3.6	3.7	2.5
<b>EBITA (\$m)</b>	<b>47.6</b>	<b>48.7</b>	<b>2.3</b>	<b>49.0</b>	<b>51.5</b>	<b>5.1</b>
Amortisation - customer contracts	4.2	6.9	64.3	5.2	11.6	123.1
EBIT (\$m)	36.2	34.3	(5.2)	43.8	39.9	(8.9)
NPAT - underlying	23.6	22.2	(5.9)	28.6	25.7	(10.1)
<b>NPAT - adjusted</b>	<b>27.8</b>	<b>29.1</b>	<b>4.7</b>	<b>33.8</b>	<b>37.3</b>	<b>10.4</b>
<b>EPS (¢) adjusted</b>	<b>22.6</b>	<b>27.1</b>	<b>4.9</b>	<b>27.1</b>	<b>30.0</b>	<b>10.7</b>
Dividend (¢)	13.5	13.5	-	16.0	17.5	9.4

Source: BGF Equities

- **FY11 impact from Clear** – we have lifted our FY11 EBITDA forecasts by \$1.0 to reflect the impact of the Clear acquisition which we estimate will contribute FY11 EBITDA of \$3.5m vs our previous acquisition forecasts for acquired EBITDA of \$2.5m. *Note: Our FY11 forecasts exclude the impact of \$2.0m in one-off costs and charges associated with the Clear acquisition. We have treated these as one-off items.*
- **FY12 acquisition assumptions remain** - We have forecast further acquisition growth for FY12 of \$5m in annualised EBITDA, with an effective acquisition date of 1 Jan. 2012. We assume an acquisition multiple of 3.5x EBITDA and 100% cash consideration.

*We estimate Clear will contribute FY11 EBITDA of \$3.5m for the 5-month period to 30 June 2011*

*Our acquisition assumptions assume acquired earnings make a 6-month contribution in the year acquired*

- **Amortisation charges** - amortisation charges in relation to customer contracts have increased by 64.3% (5-months) for FY11 and 123.1% for FY12. This increase reflects intangible assets realised in relation to customer contracts acquired from Clear, which equate to approximately 80% of the purchase price and are estimated to be amortised over a 36 month period. *MTU typically amortises acquired customer contracts over a 30 – 36-month period.*
- **Earnings upgraded** - we have increased our adjusted FY11 & FY12 EPS forecasts by 4.9% and 10.7% respectively based on the Clear acquisition (effective 1 Feb. 2011) delivering annualised EBITDA of \$8m, which is above our FY11 acquisition forecasts for annualised EBITDA of \$5m (effective 1 Jan. 2011).
- **Valuation increased by 15%** - we have increased our DCF valuation by 15% to \$3.70 per share.

## ACCC Update

- We understand the ACCC to have new enforcement powers that allows them to make an interim / draft determination (i.e. price change) that can be effective immediately, while a final determination is being made which may ultimately vary from the interim / draft determination.
- In relation to ACCC's current draft price changes for reducing wholesale pricing on a number of Telstra provided services, the ACCC, under its new enforcement powers, is currently resubmitting its draft / interim proposal which, as stated above, can be enforced immediately while a final determination is completed.
- We understand the effective date for any price adjustment will still be 1 January 2011, however the unknown is that in the event that a final price change varies from the interim what claw back or recovery mechanisms may be in place, if at all, for customers such as MTU.
- Of the pricing reductions proposed it will be the reduction in Telstra's monthly wholesale line rental service (WLR) from \$26.93 per month (for a business line) to \$20 per month that is most significant to MTU. We estimate that MTU could gain an annualised net EBITDA uplift off \$16.5m which incorporates WLR benefits attributable with the Clear Telecoms business.

## Business Support System update

We understand that the Business Support System (BSS) is 75% through the customization process with requirements to be completed by 3Q11. The new BSS is to be run in the People Telecom operations in parallel to the existing system during 4Q11, followed by a parallel roll-out within the Commander operations pre Xmas 2011.

## FINANCIALS

		Price		\$ 3.27					
M2 Telecommunications Group		Market Cap		\$ 401.6					Year end 30 June
<b>Profit &amp; Loss (\$m)</b>	<b>2009A</b>	<b>2010A</b>	<b>2011F</b>	<b>2012F</b>	<b>Valuation ratios</b>	<b>2009A</b>	<b>2010A</b>	<b>2011F</b>	<b>2012F</b>
Sales Revenue	202.5	406.1	473.4	552.3	EPS (cps) - underlying	8.8	14.6	18.1	20.6
EBITDA	13.1	31.2	45.0	55.1	EPS (cps) - adjusted	9.7	16.7	23.7	30.0
Depn & Amort	1.4	2.6	3.7	3.7	PER (x)	33.8	19.6	13.8	10.9
Amort - Identifiable Intangibles	0.8	2.4	6.9	11.6	PER Rel - All Ind.	138%	24%	-1%	-11%
EBIT	10.9	26.2	34.3	39.9	PER Rel - Small Ind.	136%	22%	-1%	-13%
Net Interest Expense	-0.5	-2.0	-2.6	-3.2	Enterprise Value (\$m)	364.2	399.0	425.5	439.0
NPBT	10.4	24.2	31.7	36.7	EV / EBITDA (x)	27.9	12.8	9.5	8.0
Tax expense	-3.0	-8.0	-9.5	-11.0	EV / EBIT (x)	33.5	15.3	12.4	11.0
NPAT - pre-sign items	7.4	16.2	22.2	25.7	DPS (cps)	5.5	10.0	13.5	17.5
NPAT - adjusted	8.2	18.5	29.1	37.3	Dividend Yield (%)	1.7%	3.1%	4.1%	5.4%
Significant items	0.0	0.0	-1.4	0.0	Franking (%)	100%	100%	100%	100%
NPAT - reported	7.4	16.2	20.8	25.7	CFPS (cps)	9.9	12.0	24.1	30.4
					P / CFPS (x)	33.1	27.3	13.5	10.7
<b>Cash Flow (\$m)</b>	<b>2009A</b>	<b>2010A</b>	<b>2011F</b>	<b>2012F</b>	<b>Profitability ratios</b>	<b>2009A</b>	<b>2010A</b>	<b>2011F</b>	<b>2012F</b>
Operating EBITDA	13.1	31.2	45.0	55.1	EBITDA Margin (%)	6.5	7.7	9.5	10.0
- Interest & Tax Paid	3.5	10.0	12.1	14.1	EBIT Margin (%)	5.4	6.4	7.3	7.2
+/- change in Work. Cap.	0.3	-6.2	1.0	0.4	ROE (%)	15.2	21.0	26.2	27.8
- other	1.5	1.7	4.1	3.5	ROA (%)	8.1	18.1	19.7	19.7
Operating Cashflow	8.3	13.3	29.7	37.9	ROIC (%)	21.4	29.9	31.8	32.5
- Capex	-0.9	-0.9	-9.0	-8.0	<b>Balance Sheet ratios</b>	<b>2009A</b>	<b>2010A</b>	<b>2011F</b>	<b>2012F</b>
- other	0.0	0.0	-3.1	-3.0	Net Debt (cash)	9.6	1.5	18.2	31.7
- equity	-9.7	-16.3	-20.2	-22.3	Net Gearing (%)	19.8	2.0	21.5	34.2
Free Cashflow	-2.4	-3.8	-2.6	4.6	Interest Cover (x)	28.4	15.7	17.0	17.5
- Ord Dividends	-4.3	-8.3	-14.8	-18.1	NTA per share (\$)	0.0	0.0	0.0	0.0
- Equity / other	0.5	20.4	0.5	0.0	Price / NTA (x)	-18.8	6.7	1.2	-2.7
Net Cashflow	-6.2	8.3	-16.9	-13.4	EPPOWA (m)	84.2	110.9	123.1	124.6
Cash at beginning of period	6.9	6.7	15.1	4.1	<b>Growth ratios</b>	<b>2009A</b>	<b>2010A</b>	<b>2011F</b>	<b>2012F</b>
+/- borrowings / other	6.0	0.1	6.0	12.0	Sales revenue (\$m)	85.8%	100.6%	16.6%	16.7%
Cash at end of period	6.7	15.1	4.1	2.7	EBITDA (\$m)	47.8%	138.3%	44.4%	22.6%
					EBIT (\$m)	43.6%	140.4%	31.3%	16.0%
<b>Balance Sheet</b>	<b>2009A</b>	<b>2010A</b>	<b>2011F</b>	<b>2012F</b>	NPAT (\$m)	43.0%	119.0%	37.5%	15.8%
Cash	6.7	15.1	4.1	2.7	EPS adj. (cps)	34.0%	72.7%	41.6%	26.6%
Inventories	1.4	0.3	0.5	0.6	DPS (cps)	10.0%	81.8%	35.0%	29.6%
PP&E	5.0	3.7	11.8	18.3	<b>Interim Analysis</b>	<b>1H10A</b>	<b>2H10A</b>	<b>1H11F</b>	<b>2H11F</b>
Debtors	49.3	55.8	63.9	74.0	Revenues	187.7	218.4	220.2	253.1
Intangibles	67.2	70.3	83.9	95.4	EBITDA	15.3	15.9	20.7	24.3
Other assets	11.7	14.1	14.1	14.1	EBITDA margin (%)	8.1%	7.3%	9.4%	9.6%
Total Assets	141.3	159.3	178.3	205.0	EBIT	12.6	13.6	18.8	15.5
Borrowings	16.3	16.6	22.3	34.3	EPS (adj)	8.7	9.7	12.2	12.2
Trade Creditors	55.1	54.2	63.4	74.0	DPS	5.0	5.0	6.0	7.5
Other Liabilities	21.6	11.5	7.4	3.9	<b>Valuation</b>				<b>2011F</b>
Total Liabilities	92.9	82.3	93.2	112.3	Normalised EBITDA multiple (x)				
NET ASSETS	48.4	77.0	85.1	92.8	EBITDA (\$m)				45.0
					Target EBITDA multiple (x)				7.6
<b>Board of Directors / Substantial Shareholders</b>					Net Debt (cash) (\$m)				18.2
Name			Shareholding	%	Implied Valuation				323.7
Craig Farrow - Chairman			0.8	0.6%	Per Share				2.55
Vaughan Bowen - CEO/MD			10.3	8.4%	<b>Target PE Multiple</b>				
Max Bowen - Non-Executive Director			0.0	0.0%	EPS (c)				23.7
John Hynd - Non Executive Director			2.8	2.3%	PER Target (x)				14.0
Michael Simmons - Non-Executive Director			0.0	0.0%	Per Share				3.31
					<b>Discounted Cash Flow</b>				
<b>Substantial Shareholders</b>			Shareholding	%	Cost of equity	13.7%	WACC		15.4%
Hunter Hall			13.7	11.1%	Cost of debt	8.0%	Terminal Growth Rate		3.5%
Vaughan Bowen			10.3	8.4%	Net Debt/ Net debt + equity	1.9%	Per Share		3.70
National Australia Bank			8.6	7.0%					
<b>Top 20 Shareholders</b>			<b>71.7</b>	<b>57.6%</b>					

**Disclosure:** There are no interests associated with the author that hold an interest in the securities of M2 Telecommunications Ltd

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