



BUY - \$3.83

M2 Telecommunications (MTU)

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ACCC comes to the party with lower access prices

Company Data

ASX Code	MTU
Price	\$3.83
12 month price target	\$4.71
12 month dividend yield	6.4%
Implied return	29.4%

Shares on issue	122.8m
Market cap	\$470.7m
12 Month price range	\$1.36/\$3.86
Monthly turnover	6.0m

Forecast Changes

	2011F	2012F	2013F
NPAT	14%	30%	31%
EPS	14%	30%	31%
DPS	14%	36%	34%

Earnings Summary

Yr to 30 June	2010	2011F	2012F	2013F
Lodge adj profit	18.5	32.1	47.5	53.4
Rep. Profit _(pre-sia)	16.1	28.9	42.9	50.6
EPS (¢) adj	16.7	26.2	38.6	43.5
EPS growth	63.5%	62.5%	48.1%	17.8%
P/E ratio	23.0 x	14.6 x	9.9 x	8.8 x
DPS (¢)	10.0	16.5	24.5	29.0
Yield	2.6%	4.3%	6.4%	7.6%
Franking	100%	100%	100%	100%
Payout ratio	69%	70%	70%	70%
EV / EBIT	18.1 x	11.3 x	7.6 x	6.2 x
EV / EBITDA	15.0 x	9.9 x	6.7 x	5.8 x
CFPS (¢)	12.0	32.6	41.7	45.7
Price / CF	31.9 x	11.7 x	9.2 x	8.4 x
NTA per share	\$0.05	-\$0.02	\$0.13	\$0.30
Pr / NTA	69.7 x	-195. x	28.5 x	12.7 x

Share Price Chart



The ACCC has issued interim access determinations (IADs) for the pricing of fixed line telecommunications services between Telstra and re-sellers. Of the six fixed line categories, access prices for wholesale line rental rates (WLR) on business lines have fallen to \$22.10 (from \$26.93) per phone per month. Local carriage costs (LCR) have also been reduced, to 9.1 cents per call (from 17c). Both determinations represent a material win for M2 Telecommunications. Our baseline EPS forecasts increase by 14% in FY11, 30% in FY12 and 31% in FY13 due to the lower cost base.

MTU forecasts \$m	11 old	11 new	%	12 old	12 new	%
Sales revenue	462.4	462.4	0%	548.8	548.8	0%
EBITDA	43.5	49.0	13%	55.2	70.5	28%
EBIT	37.4	42.9	15%	46.9	62.1	33%
Lodge adj profit	28.2	32.1	14%	36.6	47.5	30%
EBITDA / sales	9.4%	10.6%	1%	10.1%	12.8%	3%
EPS (¢)	23.0	26.2	14%	29.8	38.6	30%
EPS growth on pcp	40.8%	62.5%	22%	27.8%	48.1%	20%
DPS (¢)	14.50	16.50	14%	18.0	24.5	36%
Yield %	3.8%	4.3%	1%	4.7%	6.4%	2%

Source; Lodge Partners

IADs will be backdated to the 1st of January 2011 and be applicable until the earlier of 31st Dec 2011 or the introduction of final access determination (FAD). The IAD provides a benchmark for Telstra and re-sellers to fall back on when negotiating terms and conditions. The ACCC may further amend prices in the period between IAD and FAD, however, under the new Telecommunications legislation, we believe that this is unlikely to be material, as the original indicative WLR was at \$20.00/month and LCR at 7c- meaning that the ACCC has already negotiated & deliberated based on industry feedback.

Payments to Telstra for fixed line network access represent a significant proportion of MTU's c89% cost of sales. With contracted prices backdated to 1st Jan '11 and applicable straight away, MTU will likely receive rebates for the backdated period for the difference between \$22.10 and \$26.93 per fixed line. Based on our assumptions, MTU has between 200K and 300K fixed lines under contract with Telstra, including those acquired under the recent Clear Telecoms business. Taking a base line 260K phone number, and overlaying an average 2 local calls per phone per working day, we reach an annualised run rate for EBIT savings of \$21.8m, pre- price discounting and all else equal.

The commercial reality is that some the amended supplier terms will need to be passed through to customer via discounted plans and call rates. The extent of this discounting likely lies with industry wide trends, plus the ability of MTU to manage expectations through relationships and the hand to hand nature of the SME market. We expect that 30% of the discounted price will be priced into customer contracts from FY12. The largest EBIT run-rate gains are likely between now and early 2012 at a point when recently signed one-year contract run off. Taking these forecasts into account, our base line EBIT rises by \$5.5m in FY11 and \$15.2m during FY12. Clearly, upside/downside to these numbers exists, based on the company's ability to capture the price moves and around our assumptions of phone numbers and call frequencies.

Our DCF valuation increases to \$4.71 (from \$3.63) and we upgrade to a BUY recommendation. MTU's cash generating capacity and ability to execute acquisitions and pay higher dividends has improved materially.

Scenario analysis based on ACCC indicative prices.

Assuming a rolling 12x forward P/E multiple, our indicative estimated price target increase as follows;

- **Base line** assumptions with ACCC indicative prices falling to 9.1c (from 17c) and monthly rental falling to \$22.1 (from \$26.93) our valuation for MTU including the recently acquired Clear business rises to \$4.71 per share. Our scenario assumptions have taken into account 260K lines and assumed a 30% price pass through.

Given the attractiveness of the Clear & Austar Mobile Acquisitions, strengthening M2 cash flow, high market share in the re-selling space and proven growth model, MTU warrants a forward P/E multiple of 12x rolling 1 year forward.

Table 2: Scenario Analysis for potential FY11 & FY12 EPS based on indicative ACCC Prices

EPS upgrades.....

Local call costs 9.1c (from 17c) and monthly rental \$22.10 (from \$26.93)			
Adj EPS FY11(e) assume 1 Jan '11 price change, 30% tax, interest D&A equal			
Scenario \$ per share	60 % Capture	70% Capture	80% Capture
140K lines (120K MTU+20K Clear)	0.251	0.254	0.257
200K lines (160K MTU+40K Clear)	0.259	0.264	0.269
260K lines (200K MTU+60K Clear)	0.268	0.274	0.280
Adj EPS FY12(e) assume 1 Jan '11 price change, 30% tax, interest D&A equal			
Scenario \$ per share	60 % Capture	70% Capture	80% Capture
140K lines	0.339	0.346	0.352
200K lines	0.356	0.366	0.375
260K lines	0.373	0.386	0.398
% increase EPS FY11(e); 1 Jan '11 price change, 30% tax, interest D&A equal			
Scenario \$ per share	60 % Capture	70% Capture	80% Capture
140K lines	9.0%	10.5%	12.0%
200K lines	12.8%	14.9%	16.9%
260K lines	16.5%	19.2%	21.9%
% increase EPS FY12(e); 1 Jan '11 price change, 30% tax, interest D&A equal			
Scenario \$ per share	60 % Capture	70% Capture	80% Capture
140K lines	35.2%	36.0%	36.8%
200K lines	37.3%	38.4%	39.5%
260K lines	39.3%	40.7%	42.0%

Source; Lodge Partners, ACCC

Workings behind the EBIT upgrades.....

Wholesale Line Rental reduces to \$22.10/month (from \$26.93)*			
Scenario \$m EBIT upside	60 % Capture	70% Capture	80% Capture
140K lines (120K MTU+20K Clear)	4.9	5.7	6.5
200K lines (160K MTU+40K Clear)	7.0	8.1	9.3
260K lines (200K MTU+60K Clear)	9.0	10.5	12.1
Local Call Costs reduce to 9.1c/call (from 17c). Assume 2 calls/day per phone*			
Scenario \$m EBIT upside	60 % Capture	70% Capture	80% Capture
140K lines	2.2	2.5	2.9
200K lines	3.1	3.6	4.2
260K lines	4.0	4.7	5.4
Total annualised EBIT gain during FY12e above current Lodge forecasts			
Scenario \$m EBIT upside	60 % Capture	70% Capture	80% Capture
140K lines	7.0	8.2	9.4
200K lines	10.1	11.7	13.4
260K lines	13.1	15.3	17.5
% Increase to EBIT FY12(e) assume 1 Jan '11 price change			
Scenario %	60 % Capture	70% Capture	80% Capture
140K lines	11.3%	13.2%	15.1%
200K lines	16.2%	18.9%	21.6%
260K lines	21.1%	24.6%	28.1%
Adj EPS FY12(e) assume 1 Jan '11 price change, 30% tax, interest D&A equal			
Scenario \$ per share	60 % Capture	70% Capture	80% Capture
140K lines	0.339	0.346	0.352
200K lines	0.356	0.366	0.375
260K lines	0.373	0.386	0.398
Indicative Lodge price target from \$3.63 base, all else equal, 30% tax rate			
Scenario %	60 % Capture	70% Capture	80% Capture
140K lines	\$ 4.14	\$ 4.22	\$ 4.30
200K lines	\$ 4.35	\$ 4.46	\$ 4.58
260K lines	\$ 4.56	\$ 4.71	\$ 4.86

Source: Lodge Partners. * Assumes ACCC IAD prices are not revised under FAD

** Assumes that M2 is currently charged less than 17c per local fixed line call by Telstra

More on the ACCC indicative price changes

The ACCC delayed its announcement on indicative prices from mid December 2010 to 3rd March 2011, when the new law governing the ACCC's enforcement of Telco prices came into effect. The interim access determination (IAD) on prices will be backdated to 1 Jan '11 and will be applicable straight away to commercial arrangements between Telstra and re-sellers. The prices are intended to act as a commercial benchmark for Telstra & Access seekers when negotiating terms and conditions.

The draft report issued in late Sep '10 suggesting indicative prices of \$20.00 per month on fixed business lines (from \$26.93 per month) for a 4 year period from 1 Jan '11 and a drop in local call costs to 7c from 17c per call. The difference between these rates and the actual WLR & LCS rates proposed under the IAD, suggests that the ACCC has met Telstra somewhere near the middle in negotiations. Following further feedback from the industry, the ACCC is expected to issue final access determination (FAD) prices between now and 31 Dec '11. It is possible that there may be amendment to the rates between IAD and FAD, however, this is unlikely as the ACCC clearly intends to set the benchmark on the updated rates and the intent of lag period between IAD and FAD, is to have the industry operating on these commercial rates, once FAD is enforced. In forming the IAD, there has already been significant consultation between the ACCC and Telecommunications industry. We'd expect the ACCC to provide guidance on the 4 year time frame, once FAD prices are released.

Final determination on prices may take up to another 9 months, as the ACCC consults further with industry participants. The timing of this process may or may not be linked to Telstra's pending agreement to decommission the copper network to the NBN, as part of negotiations involving the ACCC, NBN CO, Telstra & the Federal Government. Final determination prices will be applicable from the date it is reached. This may mean that commercial prices change for 1 Jan '11 and then again from say 1 June 2011 (although material changes to pricing are unlikely).

Importantly, under the new ACCC rules following the Telecommunications Legislation Amendment Act 2010, the ACCC is in a position to enforce access determination (i.e. the ability to specify price and non-price terms for access seekers not currently subject to an existing commercial agreement with Telstra) without bi-lateral arbitration disputes.

The ACCC has used the **Regulated Asset Base (RAB) or "building block" methodology** of calculating the cost of access to the copper network, a step change from the prior "replacement-cost method" pricing from Telstra to re-sellers, a switch from the .

FY11 & FY12 earnings drivers

1) Contribution of Clever Communications, Bell Networks, Clear Telecoms and Austar Mobile 2) Synergies & Cross-Selling Opportunities between recently acquired businesses, 3) EBITDA margin expansion from cost efficiencies, 4) c8% organic earnings growth in the historical businesses 5) ACCC IAD Price changes 6) Recurring earnings model gives us confidence in management guidance

Risks to MTU

- **Acquisition integration-** M2 has acquired three sizable Telco businesses since the beginning of 2010, which presents some acquisition risk. Given the positive feedback to date, management track record of integration and increasing quality of the businesses acquired, we remain confident that unforeseen costs, issues and staff churn relating to recent acquisitions will be minimal.
- **M2 share price may run heavily in advance of the ACCC final proposal on fixed line pricing,** only to have the ACCC suspend any price changes for a further 12 months (the same scenario as occurred in Dec '09). This situation is less likely for 2010/11, as more clarity regarding the NBN is available, the Federal Election outcome is known and the Telecommunications Legislation Amendment Act 2010 has come into force since the 1st of January 2011.
- **\$12m-\$13m billing system** implementation over the coming 18 months, progressively across the M2 businesses.
- **Major Telco** Telstra stepping up competitive tension in the small and medium sized business category.

M2 Telecommunications (MTU: \$3.83)

Mkt Cap: \$470.7m



Valuation data

Year ending Jun	2009	2010	2011F	2012F	2013F
Lodge adj profit	8.1	18.5	32.1	47.5	53.4
Reported profit	7.5	16.1	28.9	42.9	50.6
EPS_{adj} (¢)	9.6	16.7	26.2	38.6	43.5
EPS growth	26.6%	63.5%	62.5%	48.1%	17.8%
P/E ratio	39.7 x	23.0 x	14.6 x	9.9 x	8.8 x
DPS (¢)	5.5	10.0	16.5	24.5	29.0
Yield	1.4%	2.6%	4.3%	6.4%	7.6%
Franking	100.0%	100.0%	100.0%	100.0%	100.0%
Payout ratio	62%	69%	70%	70%	70%
EV / EBIT	43.8 x	18.1 x	11.3 x	7.6 x	6.2 x
EV / EBITDA	36.7 x	15.0 x	9.9 x	6.7 x	5.8 x
CFPS (¢)	9.9	12.0	32.6	41.7	45.7
Price / CF	38.8 x	31.9 x	11.7 x	9.2 x	8.4 x
NTA per share	-\$0.20	\$0.05	-\$0.02	\$0.13	\$0.30
Pr / NTA	-19.1 x	69.7 x	-195.2 x	28.5 x	12.7 x

Balance sheet (\$M)

Year ending Jun	2009	2010	2011F	2012F	2013F
Cash	6.7	15.1	12.8	7.8	26.7
Receivables	50.1	55.8	63.5	75.3	81.6
Inventories	2.6	0.3	0.4	0.5	0.5
Other	2.5	7.3	7.3	7.3	7.3
Current assets	61.9	78.5	84.0	90.9	116.1
Net PPE	5.1	3.7	6.6	10.8	11.4
Investments	0.0	0.0	0.0	0.0	0.0
Goodwill	70.3	70.3	93.2	92.1	89.3
Deferred tax assets	4.1	6.7	6.7	6.7	6.7
Other	0.1	0.1	0.1	0.1	0.1
Non-current assets	79.5	80.8	106.6	109.7	107.5
Total assets	141.4	159.3	190.6	200.5	223.5
Debt	16.3	16.6	26.6	6.6	5.2
Provisions	4.1	3.6	3.6	3.6	3.6
Other	72.6	62.0	69.5	81.1	87.1
Total liabilities	92.9	82.2	99.7	91.2	95.9
Equity / reserves	42.0	63.3	63.3	63.3	63.3
Retained profits	6.5	13.7	27.5	45.3	63.0
Total s/h funds	48.5	77.0	90.8	108.5	126.3
Minorities	0.0	0.0	0.0	0.0	0.0
Total funds emp.	58.1	78.5	104.5	107.4	104.8

Ratio analysis

Year ending Jun	2009	2010	2011F	2012F	2013F
EBITDA / sales	6.5%	7.7%	10.6%	12.8%	13.1%
EBITAg / sales	5.4%	6.5%	9.4%	11.4%	12.2%
EBIT / sales	5.4%	6.4%	9.3%	11.3%	12.1%
Return on assets	8.1%	18.1%	24.1%	32.2%	36.7%
Return on equity	15.4%	20.9%	31.8%	39.6%	40.1%
Return on funds emp.	24.7%	38.2%	46.9%	58.7%	68.0%
Net debt / (cash) (\$M)	9.6	1.5	13.8	(1.2)	(21.5)
Debt / equity	33.5%	21.5%	29.3%	6.1%	4.1%
Net debt / equity	19.7%	2.0%	15.2%	(1.1%)	(17.0%)
Interest cover	23.9 x	13.1 x	28.4 x	94.9 x	-272.3 x

Profit and loss (\$M)

Year ending Jun	2009	2010	2011F	2012F	2013F
Sales revenue	202.5	406.1	462.4	548.8	594.1
<i>growth over pcp</i>	85.9%	100.6%	13.9%	18.7%	8.2%
EBITDA	13.1	31.4	49.0	70.5	77.7
Dep'n and amort'n	(2.1)	(5.0)	(5.8)	(8.0)	(5.2)
EBITAg	11.0	26.4	43.2	62.5	72.5
Goodwill amortisation	0.0	0.0	0.0	0.0	0.0
EBIT	11.0	26.1	42.9	62.1	72.2
<i>growth over pcp</i>	44.9%	137.7%	64.5%	44.7%	16.1%
Net interest expense	(0.5)	(2.0)	(1.5)	(0.7)	0.3
Pre-tax profit	10.5	24.1	41.4	61.5	72.4
Tax	(3.0)	(8.0)	(12.5)	(18.5)	(21.8)
<i>Effective tax rate</i>	28.9%	33.2%	30.2%	30.1%	30.1%
Preference dividends	0.0	0.0	0.0	0.0	0.0
Minorities	0.0	0.0	0.0	0.0	0.0
Lodge adjustments	0.7	2.4	3.2	4.5	2.8
Lodge adj profit	8.1	18.5	32.1	47.5	53.4
Reported profit (pre sig)	7.5	16.1	28.9	42.9	50.6
One-off items (post tax)	0.0	0.0	0.0	0.0	0.0
Reported net profit	7.5	16.1	28.9	42.9	50.6

Cashflow (\$M)

Year ending Jun	2009	2010	2011F	2012F	2013F
EBIT	11.0	26.1	42.9	62.1	72.2
Net interest paid	(0.7)	(2.2)	(1.5)	(0.7)	0.3
Dep'n and amort'n	2.1	5.0	5.8	8.0	5.2
Tax paid	(2.8)	(5.9)	(12.5)	(18.5)	(21.8)
Gross cash from op'ns	9.5	23.0	34.7	51.0	55.8
(Inc) / dec in w'kg cap	(1.0)	(5.0)	(0.3)	(0.4)	(0.2)
(Inc) / dec in provisions	17.5	2.1	4.9	0.0	0.0
Other	(17.7)	(6.9)	0.6	0.6	0.6
Operating cashflow	8.3	13.3	39.9	51.2	56.2
<i>growth over pcp</i>					
Investing cashflows					
Capital expenditure	(0.9)	(0.9)	(4.2)	(6.2)	(3.0)
Asset sales	0.0	0.0	0.0	0.0	0.0
Investments	(9.7)	(16.3)	(32.9)	(4.9)	0.0
Divestments	0.0	0.0	0.0	0.0	0.0
Other	0.0	0.0	0.0	0.0	0.0
Financing cashflows					
Equity raised	0.5	20.4	0.0	0.0	0.0
Dividends paid	(4.3)	(8.3)	(15.1)	(25.2)	(32.9)
Chg in loans	6.0	0.1	10.0	(20.0)	(1.4)
Other non-op flows	0.0	0.0	0.0	0.0	0.0
Net chg in cash	(0.2)	8.4	(2.2)	(5.1)	18.9

Interims (\$M) Source; Lodge Partners

MTU Half Year Split	1HY10	2HY10	1HY11	2HY11
Sales revenue	187.7	218.4	215.7	246.7
EBITDA	15.3	16.1	20.1	28.9
EBIT	12.6	13.5	17.4	25.5
Lodge adj profit	9.5	8.9	13.1	19.0
Reported profit	9.5	6.6	11.5	17.4
EBITDA / sales	8.2%	7.4%	9.3%	11.7%
EPS (¢) Adj	8.7	7.9	10.7	15.5
EPS growth on pcp	45.7%	32.3%	22.5%	95.4%
DPS (¢)	5.0	5.0	7.0	9.5
% of FY EBIT	48%	52%	41%	59%

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Expected total Return is measured as (capital gain (or loss) + dividend)/purchase price

We have divided our recommendations into three main Categories:

Buy: Expected Total Return in excess of 15% over a 1 year period.

Hold: Expected Total Return between 0% and 15% over a 1 year period.

Sell: Expected Total Return less than 0% over a 1 year period.

Analyst Verification

I verify that I, **Ian Munro**, have prepared this research report accurately and that any financial forecasts and recommendations that are expressed are solely my own personal opinions. In addition, I certify that no part of my compensation is or will be directly or indirectly tied to the specific recommendation or financial forecasts expressed in this report.

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