

M2 Telecommunications Group Ltd

Issued: 1 March 2011

Earnings trajectory continues.

MTU has reported another strong result delivering 1H11 NPAT of \$11.5m (\$13.1m adjusted) representing 40% growth on the pcp. The result included by comparable earnings growth of 29%, before the impact of the Clever Communication and Bell Networks acquisitions. We expect MTU's earnings momentum to continue into the 2H11, assisted further by recent acquisitions of Clear Telecoms. We retain our BUY recommendation, while a price target has increase to \$4.10 per share.

Recommendation: BUY
Price: \$3.66
Price Target: \$4.10
Code: MTU

Y/E December		2009A	2010A	2011F	2012F
Revenue	\$m	202.5	406.1	473.4	559.9
EBITDA	\$m	13.1	31.2	43.5	56.1
NPAT - reported	\$m	7.4	16.2	22.5	26.7
NPAT – adjusted*	\$m	8.2	18.5	29.4	38.6
EPS (adj)	CPS	9.7	16.7	23.9	31.0
EPS Growth	%	34.0%	72.7%	43.1%	29.6%
PER	x	33.8	19.6	15.3	11.8
EV/EBITDA	x	27.9	12.8	10.8	8.6
DPS	c	5.5	10.0	15.0	17.0
Yield	%	1.7%	3.1%	4.1%	4.6%

Source: BGF Equities / * Earnings adjusted for non-cash amortisation expense

Stock Data

Market Capitalisation \$449.6m
 Issued Capital 122.9m
 Volume (monthly average) 3.1m
 12-month low \$1.36
 12-month high \$3.75

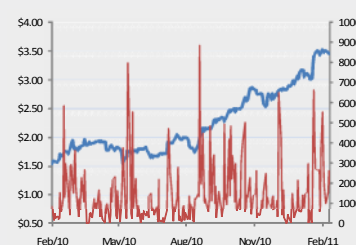
Market Data

Small Ordinaries 2863
 S&P ASX 200 4835
 All Ordinaries 4928

Valuation & Pricing Data

DCF Valuation \$4.10
 EBITDA Multiple \$4.20
 PER \$4.30

Daily Price Chart



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Underlying EBITDA growth of 36%

MTU have reported 1H11 EBITDA of \$20.1m representing of 31% growth on the pcp, with organic EBITDA growth of approximately 25%. We estimate underlying EBITDA of \$20.8m, which represents 36% growth on the pcp, and excludes \$1.3m in one-off costs associated with the Clear Telecoms acquisition (1 February 2011) and interest revenue of \$0.6m.

Cashflow strong, dividend up 40%

Operating cashflow of \$24.1 vs. \$5.6m in the pcp. The strong cashflow result driven predominantly from working capital management. The high level of cash generation helping drive the 1H11 dividend to 7cps, which represents a 65% payout ratio (pcp: 57%) on cash EPS of 10.7cps

Earnings momentum to continue – ACCC pending

We believe the earnings outlook remains positive for MTU as organic growth and margin expansion achieved in the 1H, is complimented by the recent acquisition of Clear Telecoms (1 Feb 2011) and Austar (4Q11) which are forecast to add annualised EBITDA of \$8m and \$1.5m respectively. In addition we continue to wait for the ACCC to release its determination on the possible reduction in wholesale pricing for a number of Telstra supplied services.

Recommendation remains buy – target price lifted to \$4.10 per share

We have made some modest adjustments to our forecasts, which has resulted in our EPS increasing marginally for FY11 and FY12, while our FY11 dividend forecast has increased by 11% to 15cps (pcp: 10cps). Our DCF valuation and price target is increased by 8% to \$4.10 per share, driven by increased cashflow assumptions from existing operations.

1H11 Results Summary

Table 1: 1H11 interim results analysis

(\$m) – unless stated	1H10	1H11	% Δ	Comments
Revenues	187.7	215.7	15	<i>70% organic – acquisitions added \$8.4m</i>
EBITDA - organic	15.3	19.1	25	<i>Excludes one-off costs, acquisitions and Interest revenue</i>
- acquisitions		1.7		<i>BGF estimates for Clever and Bell acquisitions</i>
EBITDA - underlying	15.3	20.8	36	
<i>Margins – underlying</i>	<i>8.1%</i>	<i>9.6%</i>		
- interest revenue	0.1	0.6		<i>Included in reported EBITDA</i>
- one-off costs		(1.3)		<i>Costs associated with the Clear Telecoms acquisitions</i>
EBITDA - reported	15.4	20.1	31	<i>Includes interest revenue & acquisition costs</i>
<i>Margins reported</i>	<i>8.2%</i>	<i>9.3%</i>		
Depreciation	(1.3)	(1.1)		<i>Below expectations</i>
EBITA	14.0	19.0	35	
Amort of Intangibles	(1.4)	(1.6)		<i>Amortisation charges for acquired customer contacts</i>
EBIT	12.7	17.4	37	
NPAT	8.2	11.5	10	
NPAT - adjusted	9.6	13.1	37	<i>Adjusted for amortisation of acquired customer contracts</i>
EPS - reported	7.5	9.3	24	
EPS - adjusted	8.7	10.7	23	<i>Cash EPS - adj. for amortisation of acquired customer contracts</i>
Dividend	5.0	7.0	40	<i>65% payout of cash EPS – 57% on the pcp</i>

Source: BGF Equities / *

Key Points:

- **Revenues** – growth of 15% on the pcp, including 10.4% organic revenue growth before the impact of acquired customer contracts in relation to Clever Communications (May 2010) and Bell Networks (August 2010).
- **EBITDA** – reported EBITDA growth of 31% on the pcp with organic EBITDA growth of approximately 25% before the impact of acquisitions. We estimate underlying EBITDA of \$20.8m, which represents 36% growth on the pcp, and excludes \$1.3m in one-off costs associated with the Clear Telecoms acquisition (1 February 2011) and interest revenue of \$0.6m.
- **Margin growth** – EBITDA margins lifted to 9.3% (pcp: 8.2%) while on an underlying basis we estimate 1H11 EBITDA margins of 9.6%. Margin expansion reflects the benefits of recent bolt-on acquisitions and associated scale benefits which are improving MTU's buying power with telco providers.
- **NPAT / EPS** – Adjusted NPAT and EPS of \$13.1m and 10.7cps representing growth of 37% and 23% respectively. Excluding the impact of acquisitions, we estimate organic NPAT growth of 29%.
- **Cashflow** – operating cashflow of \$24.1 vs. \$5.6m on the pcp, driven largely by working capital management. We expect strong ongoing cashflow to be maintained from existing operations.

Segmented summary

Retail

Table 2: Retail operations 1H11 NPBT – pre-unallocated overheads

(\$m) – unless stated	1H10	1H11	% Δ	Comments
Revenues				
- External	114.9	119.6	4.1	External revenues up
- Inter-company		21.3	-	Accounting change excludes Inter co. sales
Total Revenues	119.6	136.3	(12.3)	
NPBT – reported	13.4	13.9	3.7	
One-off costs	-	1.3		Associated with Clear Telecoms
NPBT - underlying	13.4	15.2	13.4	
Margins – underlying	11.7	12.7		

Source: BGF Equities

Revenues have been impacted by an accounting adjustment in the recognition of inter-company revenues, which will no longer be reported. The adjustment having no impact on reported earnings.

Segmented NPBT (pre-unallocated) was impacted at a reported level by one-off acquisition costs associated with the Clear Telecoms acquisition. Underlying margins improved on the pcp, however below group margin growth.

Wholesale

Table 3: Wholesale operations 1H11 NPBT – pre-unallocated overheads

(\$m) – unless stated	1H10	1H11	% Δ	Comments
Revenues	72.8	96.1	32.1	Scale and organic growth
NPBT – reported	1.8	5.3	294	
Margins – underlying	7.3	5.5		

Source: BGF Equities

Coming of a comparatively low base the Wholesale business benefited from scale and margin expansion, while cycling the impact from one-off changes in recognition of commission revenues which had a negative \$2m impact in the pcp.

Forecasts refined – modest changes

FY11 - We have made modest revisions to our EBITDA forecast, which has been more than compensated by reductions in forecast levels of depreciation and interest expense.

FY12 – marginal changes from reductions in depreciation and interest expense expectations. We note that our current forecasts assume acquisition growth to add \$2.5m in EBITDA, based on MTU acquiring \$5m on annualised EBITDA (effective 1 January 2012) for \$17.5m in cash.

(\$m) – unless stated	FY11			FY12		
	Old	New	% Δ	Old	New	% Δ
Revenues	473.4	473.4	-	562.3	559.9	(0.4)
EB TDA	45.0	43.5	(3.2)	56.6	56.1	(0.8)
EBITA	41.3	40.5	(2.0)	52.9	53.0	0.2
EBIT	34.4	33.6	(2.4)	41.0	41.1	0.2
NPAT – excl. one-off costs	22.2	22.5	1.4	28.6	26.7	1.0
NPAT – adjusted	29.1	29.4	1.1	33.8	38.6	0.7
Sig items – Clear Acq. costs	(1.4)	(1.4)	-	-	-	-
NPAT - reported	20.8	21.1	1.5	26.4	26.7	1.0
EPS (¢)	18.1	18.3	1.4	21.2	21.4	1.0
EPS (¢) adjusted	23.7	23.9	1.1	30.8	31.0	0.7
Dividend (¢)	13.5	15.0	11.1	17.0	17.0	-

Source: BGF Equities

FINANCIALS

M2 Telecommunications Group Price \$ 3.66
Market Cap \$ 449.5

Profit & Loss (\$m)	2009A	2010A	2011F	2012F
Sales Revenue	202.5	406.1	473.4	559.9
EBITDA	13.1	31.2	43.5	56.1
Depn & Amort	1.4	2.6	3.1	3.1
Amort - Identifiable Intangibles	0.8	2.4	6.9	11.9
EBIT	10.9	26.2	33.6	41.1
Net Interest Expense	-0.5	-2.0	-1.4	-3.0
NPBT	10.4	24.2	32.2	38.1
Tax expense	-3.0	-8.0	-9.6	-11.4
NPAT - pre-sign items	7.4	16.2	22.5	26.7
NPAT - adjusted	8.2	18.5	29.4	38.6
Significant items	0.0	0.0	-1.4	0.0
NPAT - reported	7.4	16.2	21.1	26.7

Cash Flow (\$m)	2009A	2010A	2011F	2012F
Operating EBITDA	13.1	31.2	43.5	56.1
- Interest & Tax Paid	3.5	10.0	11.0	14.4
+/- change in Work. Cap.	0.3	-6.2	6.2	2.2
- other	1.5	1.7	4.1	3.2
Operating Cashflow	8.3	13.3	34.6	40.7
- Capex	-0.9	-0.9	-9.0	-8.0
- other	0.0	0.0	-3.1	-3.0
- equity	-9.7	-16.3	-22.2	-22.3
Free Cashflow	-2.4	-3.8	0.3	7.4
- Ord Dividends	-4.3	-8.3	-14.8	-19.9
- Equity /other	0.5	20.4	0.5	0.0
Net Cashflow	-6.2	8.3	-14.1	-12.5
Cash at beginning of period	6.9	6.7	15.1	7.0
+/- borrowings / other	6.0	0.1	6.0	12.0
Cash at end of period	6.7	15.1	7.0	6.5

Balance Sheet	2009A	2010A	2011F	2012F
Cash	6.7	15.1	7.0	6.5
Inventories	1.4	0.3	0.5	0.6
PP&E	5.0	3.7	12.2	18.7
Debtors	49.3	55.8	61.5	71.4
Intangibles	67.2	70.3	86.1	97.9
Other assets	11.7	14.1	14.1	14.1
Total Assets	141.3	159.3	181.4	209.1
Borrowings	16.3	16.6	22.3	34.3
Trade Creditors	55.1	54.2	66.3	78.4
Other Liabilities	21.6	11.5	7.4	4.2
Total Liabilities	92.9	82.3	96.0	116.9
NET ASSETS	48.4	77.0	85.4	92.2

Board of Directors / Substantial Shareholders			
Name	Shareholding	%	
Craig Farrow - Chairman	0.8	0.6%	
Vaughan Bowen - CEO/MD	10.3	8.4%	
Max Bowen - Non-Executive Director	0.0	0.0%	
John Hynd - Non Executive Director	2.8	2.3%	
Michael Simmons - Non-Executive Director	0.0	0.0%	

Substantial Shareholders			
	Shareholding	%	
Hunter Hall	13.7	11.1%	
Vaughan Bowen	10.3	8.4%	
National Australia Bank	8.6	7.0%	

Top 20 Shareholders 71.7 57.6%

Year end 30 June

Valuation ratios	2009A	2010A	2011F	2012F
EPS (cps) - underlying	8.8	14.6	18.3	21.4
EPS (cps) - adjusted	9.7	16.7	23.9	31.0
PER (x)	37.8	21.9	15.3	11.8
PER Rel - All Ind.	166%	39%	10%	-4%
PER Rel - Small Ind.	165%	37%	9%	-6%
Enterprise Value (\$m)	406.5	446.4	471.2	483.8
EV / EBITDA (x)	31.1	14.3	10.8	8.6
EV / EBIT (x)	37.4	17.1	14.0	11.8
DPS (cps)	5.5	10.0	15.0	17.0
Dividend Yield (%)	1.5%	2.7%	4.1%	4.6%
Franking (%)	100%	100%	100%	100%
CFPS (cps)	9.9	12.0	28.1	32.7
P / CFPS (x)	37.1	30.5	13.0	11.2

Profitability ratios	2009A	2010A	2011F	2012F
EBITDA Margin (%)	6.5	7.7	9.2	10.0
EBIT Margin (%)	5.4	6.4	7.1	7.3
ROE (%)	15.2	21.0	26.5	29.0
ROA (%)	8.1	18.1	19.2	20.3
ROIC (%)	21.4	29.9	31.7	35.4

Balance Sheet ratios	2009A	2010A	2011F	2012F
Net Debt (cash)	9.6	1.5	15.3	27.8
Net Gearing (%)	19.8	2.0	18.0	30.3
Interest Cover (x)	28.4	15.7	31.5	18.9
NTA per share (\$)	0.0	0.0	0.0	0.0
Price / NTA (x)	-18.8	6.7	-0.7	-5.7
EFPOWA (m)	84.2	110.9	123.1	124.6

Growth ratios	2009A	2010A	2011F	2012F
Sales revenue (\$m)	85.8%	100.6%	16.6%	18.3%
EBITDA (\$m)	47.8%	138.3%	39.8%	28.9%
EBIT (\$m)	43.6%	140.4%	28.3%	22.5%
NPAT (\$m)	43.0%	119.0%	39.5%	18.5%
EPS adj. (cps)	34.0%	72.7%	43.1%	29.6%
DPS (cps)	10.0%	81.8%	50.0%	13.3%

Interim Analysis	1H10A	2H10A	1H11F	2H11F
Revenues	187.7	218.4	215.7	257.7
EBITDA	15.3	15.9	20.8	22.8
EBITDA margin (%)	8.1%	7.3%	9.6%	8.8%
EBIT	12.6	13.6	18.1	15.5
EPS (adj)	8.7	9.7	11.4	12.6
DPS	5.0	5.0	7.0	8.0

Valuation	2012F
Normalised EBITDA multiple (x)	
EBITDA (\$m)	56.1
Target EBITDA multiple (x)	10.0
Net Debt (cash) (\$m)	27.8
Implied Valuation	533.5
Per Share	4.20

Target PE Multiple	
EPS (c)	31.0
PER Target (x)	13.9
Per Share	4.30

Discounted Cash Flow			
Cost of equity	13.5%	WACC	15.4%
Cost of debt	8.0%	Terminal Growth Rate	3.5%
Net Debt/ Net debt + equity	1.9%	Per Share	4.10

Disclosure: The author holds securities in M2 Telecommunications Group Ltd

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