

FY12 signals a new era

Investment Highlights

- M2 Telecom. (MTU) delivered a strong FY11 result that was largely in line with our expectations. EBITDA grew by 51.0% to \$47.5m while NPAT grew by 69.6% to \$27.9m. Importantly, two key strategic changes were outlined with the result. Vaughan Bowen will step aside as CEO after 12 years with Geoff Horth (COO) assuming the position. Secondly, with the elimination of \$55.0m of non-margin revenues in FY12, EBITDA margins are forecast by management to expand further to circa 15.0% (from 11.1% in FY11). We rate MTU a BUY with a target price of \$3.41 (from \$4.35).**
- FY11 result key points**
 - Revenue of \$426.8m, up 5.1% (PSL \$465.0m)
 - EBITDA of \$47.5m, up 51.0% (PSL \$49.1m)
 - Reported NPAT of \$27.9m, up 69.6% (PSL \$27.7m)
 - Underlying NPAT of \$31.3m, up 69.1% (excludes non-cash amortisation costs of acquired customer contracts)
 - DPS of 16.0 cps, up 60.0% (PSL 15.7 cps)
- Forecasts downgraded by circa 12.0%.** With pending 'material incremental investments in sales channels, lead generation and targeted marketing', we have downgraded our NPAT expectations by 12.1% in FY12 and 10.9% in FY13. Our FY12 forecasts are at the top end of management guidance for NPAT of between \$30.0m and \$34.0m. We forecast a 3 year EPS CAGR of 18.1% and note that better than expected results from these investment initiatives could provide upside to these forecasts in FY13 and beyond.
- Changing of the guard.** Mr Bowen will focus on acquisition targets, key carrier / supplier relationships and Group strategy under an Executive Director role rather than day to day activities. While some may be disappointed by Mr Bowen's decision, his concentration will be on strategic opportunities leading into full scale rollout of the NBN, which we see as a positive. In his place, Geoff Horth will assume CEO responsibilities as of 28 October 2011. Mr Horth has 20 years experience in the sector, 2.5 years of which as a member of MTU's executive team.

30 August 2011

12mth Rating		BUY
Price	A\$	2.73
Target Price	A\$	3.41
12m Total Return	%	31.8

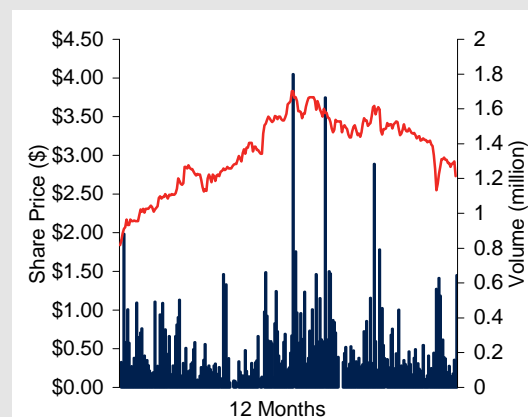
RIC: MTU.AX		BBG: MTU AU	
Shares o/s	m		123.6
Free Float	%		91.0
Market Cap.	A\$m		337.5
Net Debt (Cash)	A\$m		17.2
Net Debt/Equity	%		18.3
3m Av. D. T'over	A\$m		0.66
52wk High/Low	A\$		3.83/1.84
2yr adj. beta			1.01

Valuation:		
Methodology		Blended
Value per share	A\$	3.41

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Year End June 30	2010A	2011A	2012F	2013F	2014F
Reported NPAT (\$m)	16.2	27.6	33.9	41.3	47.0
Recurrent NPAT (\$m)	16.2	27.6	33.9	41.3	47.0
Recurrent EPS (cents)	14.4	22.2	26.9	32.5	36.6
EPS Growth (%)	66.9	54.0	21.3	20.7	12.5
PER (x)	18.9	12.3	10.1	8.4	7.5
PEG	0.3	0.2	0.5	0.4	0.6
EBITDA (\$m)	31.4	47.5	61.5	68.5	73.4
EV/EBITDA (x)	9.8	7.5	5.7	4.9	4.3
Free Cashflow	12.4	30.4	32.5	41.5	45.9
FCFPS (cents)	11.1	24.4	25.8	32.7	35.7
PFCF (x)	24.6	11.2	10.6	8.4	7.6
DPS (cents)	10.0	16.0	19.0	23.0	26.0
Yield (%)	3.7	5.9	7.0	8.4	9.5
Franking (%)	100.0	100.0	100.0	100.0	100.0

12 Month Share Price Performance



Performance %	1mth	3mth	12mth
Absolute	-9.7	-16.2	59.7
Rel. S&P/ASX 300	-9.5	-17.3	46.8

FY11 Financials

MTU reported FY11 revenue of \$426.8m; up 5.1% on the pcp. EBITDA came in at \$47.5m implying growth of 51.0%. This was negatively impacted by \$1.5m of debtor provisions relating to the edirect acquisition.

Figure 1: Financial Performance

\$m	FY10	FY11	% Change
Revenue	406.1	426.8	5.1
EBITDA	31.4	47.5	51.0
EBIT	26.5	41.5	56.8
NPAT	16.5	27.9	69.6
EPS (cents)	14.4	22.2	54.0
\$m	FY10	FY11	
Operating Cashflow	13.3	39.7	
Capital Expenditure	(0.9)	(9.4)	
Free Cashflow	12.4	30.4	
Net Change in Cash	8.4	(2.5)	

Source: M2 Telecom., Patersons Securities

Figure 2: Balance Sheet

\$m	FY10	FY11
Cash	15.1	12.5
Receivables	55.8	51.2
Intangibles	70.5	116.6
Total Assets	159.5	201.4
Creditors	54.2	57.5
Gross Debt	16.6	29.7
Shareholder Equity	77.0	93.8
Net Debt (Cash)	1.5	17.2

Source: M2 Telecom., Patersons Securities

Divisionally, Retail contributed 2.6% revenue growth (60.4% of Group revenue) while Wholesale contributed 9.2% revenue growth (39.6% of Group revenue). A swing factor in the 2H11 was Clear Telecoms shifting its revenue from the Wholesale division to the Retail division (post February acquisition). Stripping this out, we believe organic growth was sub 5.0% across the business.

At the Group level, FY11 EBITDA margins improved to 11.1% from 7.8%. Importantly, 2H11 margins improved to 13.0% from 9.3%. Expansion of margins was delivered from improving business efficiencies and as a result of improved wholesale buying economies (improved buying terms as well as benefit from ACCC determinations).

While segmental EBITDA is not reported by the Company, Retail contributed 78.3% of earnings before tax and corporate costs to the Group (Retail \$23.0m vs Wholesale \$6.4m). Group NPAT was \$27.9m, implying 69.6% growth. With minor dilution from employee option and DRP share issuance, EPS growth was 55.0%.

A fully franked final dividend of 9.0 cps was declared (full year dividend of 16.0 cps, up from FY10 10.0 cps). This was in accordance with MTU's intention to pay out circa 70.0% of NPAT.

Operating cash flows improved to \$39.7m from \$13.3m. A positive working capital movement and a lower than anticipated tax payment aided the cash flow result. Capital expenditure levels increased to \$9.4m, largely due to expenditure on MTU's new Business Support System (BSS).

Net cash generated was -\$2.5m. This was a result of \$29.0m of acquisitions and investments, \$5.9m of deferred consideration, \$12.1m of dividends paid and \$14.2m of equity and debt movements.

MTU's cash balance was \$12.5m as at 30 June 2010 while gross debt was \$29.7m. Net debt of \$17.2m was better than our expectations and remains conservative. MTU's balance sheet thus maintains headroom for further acquisitions.

The other important note within the FY11 result was the decision for Vaughan Bowen to step aside from the CEO & Managing Director positions, assuming a new role as Executive Director. Geoff Horth (MTU's COO) will be appointed as CEO following conclusion of the 28 October 2011 AGM.

With Mr Bowen concentrating his activities on 'acquisition targets, key carrier / supplier relationships, Group strategy' going forward and with MTU's recent appetite for acquiring and integrating similar styled businesses, we see further acquisitions as highly likely.

FY12 Outlook

In depth guidance for FY12 was provided by management. This included: EBITDA of between \$58.0m and \$62.0m; NPAT of between \$30.0m and \$34.0m; and EPS of between 24.0 cps and 28.0 cps.

In our view, within the FY12 guidance are expectations for between 7.5% and 10.0% organic growth, material improvements in MTU's wholesale purchasing arrangements for certain services (ACCC determinations) and incremental benefits from full year acquisition contributions.

Additionally, MTU is looking to make material investments in sales channels, lead generation and targeted marketing. Specifically, one-off costs in FY12 relate to:

- Implementing national brand consolidation;
- Establishment of expanded SMB dealer / agent channel; and
- Realising business efficiencies from Ninja implementation (Ninja is the name for MTU's new BSS).

Lastly, MTU is looking to eliminate approximately \$55.0m of unprofitable, non-margin revenues in FY12. The end result of this is target EBITDA margins of 15.0%.

Within the above commentary are some significant alterations. As such we have made some adjustments to our forecasts. Our resulting forecasts are tabled below.

Figure 3: Forecast changes

	FY12 old	FY12 new	Change	FY13 old	FY13 new	Change
	\$m	\$m	%	\$m	\$m	%
Total Revenue	549.8	415.4	-24.5%	583.8	447.8	-23.3%
EBITDA	67.1	61.5	-8.4%	75.5	68.5	-9.2%
Depreciation	-3.5	-1.8	-50.0%	-1.4	-2.4	69.7%
Amortisation	-5.5	-6.1	11.2%	-2.2	-3.4	54.4%
EBIT	58.1	53.6	-7.8%	69.2	62.7	-9.3%
Net Interest	-2.0	-1.6	-17.9%	-1.6	-1.1	-32.9%
Operating Profit	56.1	51.9	-7.4%	67.6	61.7	-8.8%
Tax expense	-17.7	-18.1	2.2%	-21.3	-20.4	-4.2%
NPAT	38.5	33.9	-12.1%	46.3	41.3	-10.9%
EPS	30.8	26.9	-12.6%	37.0	32.5	-12.2%

Source: Patersons Securities

Aside from removing the \$55.0m of eliminated revenue, the most notable assumption change is considering upwards of \$5.0m in investment costs relating to redundancies & new employments (in separate business operating units) and additional costs for closure and movement of offices. After finalisation of the ACCC determinations, we expect lower than originally anticipated benefits from these determinations. This has led us to pull back our FY12 EBITDA forecast to \$61.5m from \$67.1m. Our FY12 EBITDA forecast is thus towards the top end of management guidance.

Organic growth going forward will likely be driven from MTU's extensive dealer channels (over 450 sales people in Commander and People Telecom dealerships) where MTU is looking to concentrate branding around 'Commander' with improvement programs being initiated across sales teams. We have assumed organic growth of 7.5% in our forecasts.

We forecast FY12 NPAT of \$33.9 and EPS of 26.9 cps, both of which are towards the top end of management guidance. FY12 DPS is forecasts to be 19.0 cps which implies a 7.0% yield and assumes a dividend payout ratio of 70% of NPAT.

Improvement in MTU's FY12 operating cash flow is expected, albeit marginal over FY11 due to significantly higher tax payments (FY12 \$15.4m vs FY11 \$4.1m). Our expectation for capital expenditure in FY12 is \$9.2m which is largely in line with FY11 and assumes \$5.0m for Ninja BSS and \$4.2m for other expenditure. After considering deferred payments of \$6.2m, dividend payments of \$17.3m and debt repayments of \$7.5m, we forecast a net cash inflow of \$1.5m. Net debt at 30 June 2012 is expected to be \$8.2m.

Additional complementary acquisition targets will no doubt be looked at by MTU. As with prior acquisitions, we expect targets could be 'bolt-on' businesses with SMB assets or wholesale offerings. Acquisitions based on complimentary products (such as hosted PBX) may also eventuate. Such acquisitions could indicate a strategic move into the emerging Cloud IT market, although we believe the basis for this would still surround a reseller model rather than asset ownership. We have not included the impact of any acquisitions in our forecasts.

In the short term, risks relate to the continued integration of the AUSTAR, Clear and Edirect acquisitions and the implementation of the Ninja BSS. We also believe with the Telecoms market becoming increasingly competitive, there is a likelihood of increasing bad debts (customers in both the Retail and Wholesale divisions going out of business). We have assumed this to be the case in our model and note that MTU has systems in place to minimise damage under these circumstances.

Valuation

We have included other listed Australian telecommunications providers in MTU's peer group. This is summarised below:

Figure 6: Peer Group Relative Multiples

Code	Company	Market 3 year EPS		EV/EBITDA (x)			PE (x)		
		Cap. \$m	CAGR %	FY11	FY12	Hist Ave	FY11	FY12	Hist Ave
TPM	TPG Telecom	1,129	18.6	5.4	4.9	5.2	14.9	10.8	11.5
IIN	iiNet Ltd	357	14.3	4.2	3.6	4.1	10.7	8.3	9.3
AMM	Amcom Telecom.	207	15.1	6.9	6.0	4.2	44.2	40.0	6.4
VOC	Vocus Comm.	112	16.0	9.8	7.1	5.9	15.8	13.6	11.0
	Average		16.0	6.6	5.4	4.9	21.4	18.2	9.5
MTU	M2 Telecom.	338	18.1	7.5	5.7	4.4	12.4	8.9	7.8

Source: Patersons Securities

MTU is currently trading on 5.7 times our forecast FY12 EBITDA. This is below the peer group FY12 average of 5.9 times (excluding IIN) and is above the peer group historical average.

We forecast MTU will generate a 3 year EPS CAGR of 18.1%. This is above the current peer group average. Additionally, MTU is in a more conservative net debt position as compared to peers (except AMM).

We have used 6.5 times EBITDA as our target multiple for MTU, a 10.0% premium to the peer group. Applying this to our \$61.5m FY12 EBITDA forecast results in our target EV/EBITDA value of \$3.11 per share.

We value MTU at \$3.70 on a Discounted Cash Flow basis. The DCF considers MTU's long term growth prospects using a long term growth rate of 3.0% and a weighted average cost of capital 12.6%.

Equal weighting the relative multiple valuation and the DCF valuation results in our 12-month price target of \$3.41.

We note that this is below our previous price target of \$4.35 as a result of the lower forecasted earnings, a lower relative multiple applied (due to recent sector weakness) and a higher weighted average cost of capital applied.

M2 Telecommunications Group

\$2.73

Year End June 30

Company Background

MTU was established in 1999 and listed on the ASX in April 2004. Via organic growth and numerous acquisitions, MTU has established itself as Australia's largest reseller of telecommunications services.

MTU offers a wide range of services encompassing fixed-line, mobile, mobile broadband and complex data services. Services are predominantly offered to small and medium sized businesses and small telco customers in Australia and New Zealand.

Ratios	2010A	2011A	2012F	2013F	Cash Flow (\$m)	2010A	2011A	2012F	2013F
Profitability					Profit & Loss (\$m)				
Revenue Growth (%)	100.6	5.1	-2.7	7.8	Total Income	406.1	426.8	415.4	447.8
EBITDA Margin (%)	7.7	11.1	14.8	15.3	EBITDA	31.4	47.5	61.5	68.5
EBIT Margin (%)	6.5	9.7	12.9	14.0	Depreciation	-1.5	-1.4	-1.8	-2.4
Effective Tax Rate (%)	32.7	31.4	32.0	32.0	Amortisation	-3.5	-4.6	-6.1	-3.4
ROE (%)	26.2	32.7	33.2	34.4	EBIT	26.5	41.5	53.6	62.7
ROA (%)	10.9	15.5	16.6	19.2	Interest	-2.0	-0.8	-1.6	-1.1
Payout Ratio (%)	69.4	71.0	70.0	70.0	Operating Profit	24.5	40.7	51.9	61.7
EV/EBITDA (x)	10.8	7.5	5.6	4.8	Tax expense	-8.0	-12.8	-18.1	-20.4
					Minority Interest	0.0	0.0	0.0	0.0
Balance Sheet					NPAT	16.5	27.9	33.9	41.3
Net Debt (Cash) (\$m)	1.5	17.2	8.2	-11.6	Normalised NPAT	19.2	31.4	38.4	43.3
Net Debt/Equity (%)	2.0	18.3	7.4	na					
Interest Cover (x)	13.3	52.7	32.6	58.5	Cash Flow (\$m)				
NTA (\$/share)	0.06	-0.18	0.00	0.18	EBITDA	31.4	47.5	61.5	68.5
Price/NTA (x)	46.8	-14.9	na	15.2	Net interest	-2.0	-0.8	-1.6	-1.1
EFPOWA (m)	112.1	124.5	125.8	127.0	Income tax paid	-5.9	-4.1	-15.4	-19.2
					Working capital change	-6.2	7.8	-2.7	-2.2
					Other	-4.1	-10.7	0.0	0.0
					Operating Cashflow	13.3	39.7	41.6	46.0
					Capital expenditure	-0.9	-9.4	-9.2	-4.5
					Free Cashflow	12.4	30.4	32.5	41.5
					Acquisitions & Invest.	-3.8	-29.0	-6.2	0.0
					Disposals	0.0	0.0	0.0	0.0
					Increase (Repay) Debt	0.1	13.2	-7.5	-5.0
					Equity Raised	20.4	1.0	0.0	0.0
					Dividends paid	-8.3	-12.1	-17.3	-21.7
					Other	-12.5	-5.9	0.0	0.0
					Net Change in Cash	8.4	-2.5	1.5	14.8
					Net Exch. Differences	0.0	0.0	0.0	0.0
					Closing Cash Balance	15.1	12.5	14.0	28.8

Board of Directors

Name	Position
Craig Farrow	Chairman
Vaughan Bowen	Managing Director / CEO
Max Bowen	Non-Executive Director
John Hynd	Non-Executive Director
Michael Simmons	Non-Executive Director

Shareholder

Shareholder	Shares(m)	%
Hunter Hall	12.4	9.9
Cornish Group Investments	10.3	8.2
Vaughan Bowen	8.4	6.7
National Australia Bank	8.2	6.6

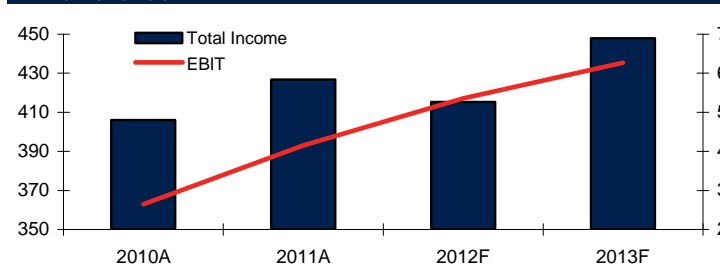
Top 20 Shareholders

74.9 60.0

Balance Sheet (\$m)

Balance Sheet (\$m)	2010A	2011A	2012F	2013F
Cash	15.1	12.5	14.0	28.8
Receivables	55.8	51.2	52.4	58.9
Inventories	0.3	0.4	0.4	0.4
Investments	0.0	0.0	0.0	0.0
Fixed Assets	3.7	3.4	10.8	12.9
Intangibles	70.5	116.6	110.5	107.1
Other Assets	14.1	17.3	17.3	17.3
Total Assets	159.5	201.4	205.4	225.4
Creditors	54.2	57.5	55.9	60.3
Current Borrowings	5.1	12.5	12.5	12.5
Non-current Borrowings	11.4	17.3	9.8	4.8
Other Liabilities	11.7	20.4	16.9	18.0
Total Liabilities	82.5	107.6	95.0	95.6
Minority Interests	0.0	0.0	0.0	0.0
Shareholders Funds	77.0	93.8	110.4	129.9

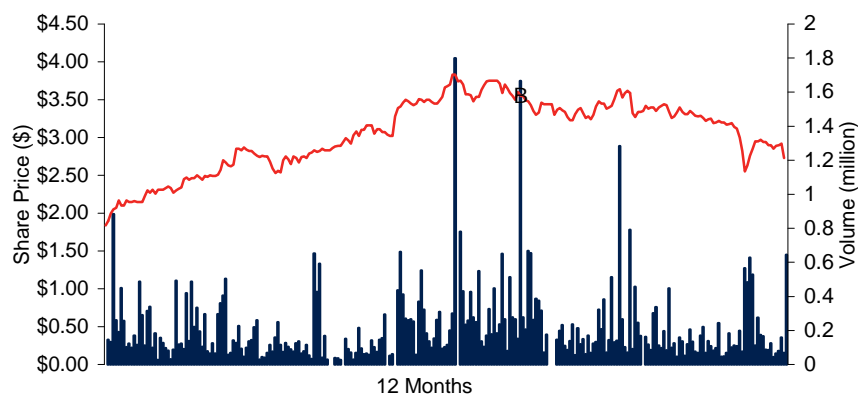
EBIT/Revenue



Valuation

Valuation	2010A	2011A	2012F	2013F
Normalised EBITDA Multiple				
EBITDA (\$m)	31.4	47.5	61.5	68.5
EBITDA Multiple (x)	6.5	6.5	6.5	6.5
Net Debt (Cash) (\$m)	1.5	17.2	8.2	-11.6
Implied Valuation (\$m)	202.9	291.6	391.3	457.0
Per Share	\$1.81	\$2.34	\$3.11	\$3.60
Target PE Multiple				
EPS (cents)	14.4	22.2	26.9	32.5
PE Target (x)	12.0	12.0	12.0	12.0
Per Share	\$1.73	\$2.66	\$3.23	\$3.90
Discounted Cash Flow				
Cost of Equity	13.5%	WACC		12.6%
Cost of Debt	4.8%	Terminal G. Rate		3.0%
Target Equity/Debt	90/10	Per Share		\$3.70
Current Share Price Discount (Premium) to Val.n				35.7%

Recommendation History



Date	Type	Target Price	Share Price	Recommendation	Return
08 Apr 11	Research Note	4.35	3.56	B	
08 Apr 11	IT & Telcoms Review	4.35	3.56	B	
	Current Share Price		2.73		-23.3%

Stock recommendations: Investment ratings are a function of Patersons expectation of total return (forecast price appreciation plus dividend yield) within the next 12 months. The investment ratings are Buy (expected total return of 10% or more), Hold (-10% to +10% total return) and Sell (> 10% negative total return). In addition we have a Speculative Buy rating covering higher risk stocks that may not be of investment grade due to low market capitalisation, high debt levels, or significant risks in the business model. Investment ratings are determined at the time of initiation of coverage, or a change in target price. At other times the expected total return may fall outside of these ranges because of price movements and/or volatility. Such interim deviations from specified ranges will be permitted but will become subject to review by Research Management. This Document is not to be passed on to any third party without our prior written consent.

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