

**M2 Telecommunications Group**

**MTU**

**11 September 2007**

*With Orion coming into orbit, M2's stars are in alignment*

**Recommendation: Buy**

**Investment Rationale**

A small telco with a reliable upward trend in revenues, profits AND dividends? Sounds amazing, but that's M2 Telecommunications Group Limited (MTU). Listed in October 2004, M2 has now delivered its fifth straight record profit. M2 was named for the fourth consecutive year as one of the fastest growing companies in the 2006 BRW Fast 100 list. M2's focus on profitability is home grown but it has added to its success by careful acquisitions. M2 is now in a position to offer the full range of telco services to small and medium businesses, nationwide buying groups, associations and mid-tier corporates, small / mid-sized telecommunications service providers, with online mobile phone retailing and Green Mobiles – mobile phone services powered by the Optus 3G network. M2 expects to acquire **Orion** Telecommunications Limited (OTL) via a scheme of arrangement in early October, raising group revenues to near \$100m pa. M2 has net cash and is committed to build both its strength and dividends. Buy.

**FY07 results**

In a year of consolidation in which M2 broadened and strengthened its management team and processes, including the launch of its Optus-powered wholesaling operations, consolidation of offices and three recent acquisitions. Revenues grew 31% from \$33.5m to \$43.8m. EBIT was \$3.23m, up 13%. NPAT of \$2.41m was up 10%. EPS (basic and diluted) was 4.0¢, up 8.1%. M2 will pay a final dividend of 2¢ (ex-date 9 October) making 3¢ for the year. Net operating cash flows rose 80% from \$1.9m to \$3.4m. This left cash of \$2.6m (net \$2.4m) after investment of \$1.6m in acquisitions, \$0.6m in fixed assets and payments of \$1.8m in dividends.

**M2 Core Operations**

M2's original core SME division, with its Phone & Fly and other loyalty programs, carried out a major restructure of its exclusive third party sales channel of accredited agents. Revenues (\$30m+) and profits were fairly flat. We expect M2 Telecom to grow with its revitalized sales channel and wider range of service offerings including wireless data, 3G mobiles and high speed broadband.

M2 Wholesale now has agreements with some 14 mobile services customers. Revenues from these operations were over \$8m over the year, from zero base. We estimate a current run rate of \$13m+ pa and increasing profit contribution. The May acquisition of **WCG** (Morning Notes, 10 May, Buy at 62¢) brought some 250 ISP customers, doubled wholesale revenues and enhanced data services. The relationship with Optus is excellent and M2's offering is enhanced by Optus' \$800m commitment to expand its 3G mobile network throughout Australia.

**M2 Developments & Acquisitions**

In July, **Capricorn Society**, Australia's largest automotive industry buying group, appointed M2 as its preferred and recommended telecoms service provider. This significant coup is the first of what M2 plans as a broad foray into working with major groups to provide customised support for their members and clients.

**Wholesale Communications Group**, WCG, is Australia's largest independent data services wholesaler. Bought for shares and cash at a 3.7x NPAT, it adds ~\$16m to revenues and competencies. **Tenex Communications** brought SME customers, revenue and earnings for \$0.5m and is already integrated.

**Orion Telecommunications** is a major acquisition - a full service telco service provider based in Hobart, trading as Southern Cross Telco with over 25,000 customers and \$30m revenues. M2 will retain the Australian operations and team and complementary IP and systems, bulking up incomes and strength.

**Recommendation Impact**

M2's track record and new platform for growth recommend it strongly as a Buy.

**Snapshot**

Last Price	\$0.785
Market Cap.	\$47 million
52 Week High	\$1.00
52 Week Low	\$0.31
Sector	Telecommunication Services

**Investment Fundamentals**

Year-end Jun	FY06A	FY07A	FY08E	FY09E
NPAT (\$m)	2.2	2.4	5.1	6.6
EPS (c)	3.7	4.0	6.9	8.4
EPS Growth (%)	16.2	8.1	72.5	21.7
PE Ratio (x)	21.2	19.6	11.4	9.3
DPS (c)	2.6	3.0	4.8	6.0
Franking (%)	100	100	100	100
Dividend Yield (%)	3.3	3.8	6.1	7.6

Source: Intersuisse estimates

**Price Chart**



**Business Description**

MTU is a profitable telecommunications service provider providing network independent fixed line, mobile and data telecommunications services Australia wide and in NZ. It has a unique bundled offering targeted mainly at the Small and Medium Enterprise (SME) market and distributed through a network of dealerships and agencies. M2 also operates a wholesale services division, established on its appointment in May 2006 as the exclusively endorsed aggregator / enabler (wholesaler) of Optus mobile services to other telco service providers and ISP's.

Analyst: Peter Russell

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**The Strong New Base for M2**

M2 has 60.17m shares on issue and this will rise to 78.35m assuming the Orion Scheme of Arrangement is completed, likely on 11 October. In the Scheme booklet, proforma accounts are provided to 31 December 2006. These show, for Orion for the half-year to 31.12.06, relevant sales at \$17.1m, EBITDA of \$1.7m, EBIT of \$1.6m and NPAT of \$1.1m. We expect, as a starting point, annual Orion sales of \$31m and NPAT of \$2.2m with a minimum of \$2.0m an upside of \$2.5-3.0m.

Independent Expert Lonergan Edwards gives proforma figures for M2 (pre-Orion), assuming ownership of Tenex and WCG for the full year, of \$56.9m revenues, \$5.4m EBITDA, \$4.7m EBIT and \$3.4m NPAT. The NPAT figure comprises \$2.4m for MTU, \$0.2m for Tenex and \$0.8m for WCG.

We have based our FY08 figures in the page 1 table on these figures, allowing pro-rata Orion from 11 October, with a minor 5% growth on M2 core business and adjustment for EPS on weighted share capital. For FY09 we have started from full year combined figures, with an 18% uplift in NPAT over the one-to-two year timeframe. We consider these estimates are likely to prove conservative once the acquisitions are bedded down, in view of the synergies that should apply and the complementary 3G, broadband and data service offerings that should strongly assist revenue growth, without putting strain on the enlarged management and infrastructure capacities.

**M2 background based on the FY07 Preliminary Final report**

**A successful inaugural year for M2 Wholesale**

M2 Wholesale had commercial wholesale agreements with 14 wholesale mobile services customers, including several well established telecoms companies and Internet Service Providers (ISP's). Revenue generated from Optus mobile wholesaling operations exceeded \$8 million, from zero base 12 months earlier. Most importantly, the M2 Wholesale business is now a valuable contributor to earnings.

In May, M2 acquired Australia's leading independent wholesaler of data services, Wholesale Communications Group Pty Ltd (WCG). This brought some 250 wholesale customers, nearly \$17m annualised revenues and solid profitability while considerably enhancing M2's data know-how and wholesale processes.

Now accounting for around 23% of M2 revenues, the strong growth of M2's wholesale business in FY07 is expected to continue in FY08.

**M2 first to market with Optus 3G**

In February 2007 M2 completed its enablement as the first Optus Mobile Virtual Network Operator (MVNO) to "go live" with Optus 3G mobile voice and data services.

Optus 3G is a powerful extension to the M2 product suite, with high demand from both of M2's Telecom and Wholesale divisions, expected to increase considerably as 3G services become more widely used and numbers of 3G compatible mobiles grow. Video calling, expanded content services, mobile TV and wireless broadband data are now available to all M2's customers.

**M2 Telecom relaunches Accredited Agents network**

FY07 was busy for M2's small enterprise telco services division, M2 Telecom. M2 comprehensively revitalised its third party sales channel, its trans-Tasman network of M2 Accredited Agents. The trained sales professionals in the network are each allocated a territory to represent the M2 Telecom services and associated loyalty programs.

M2's Phone and Fly® small business loyalty program remains the cornerstone, where customers are gifted up to 15% of their spend on M2 Telecom services in unencumbered "Travel Dollars" available to be spent on flights, accommodation, rental cars etc. In January, after years of alliance with travel agency groups as fulfilment providers, M2 launched a dedicated travel business, "M2 Travel", with an independent travel company, to enhance the travel redemption experience of customers.

**M2 the preferred telco supplier to Capricorn Society**

In July, after several months of competitive review and negotiation, Capricorn Society, Australia's largest automotive industry buying group, appointed M2 as its preferred and recommended telecoms services provider.

Capricorn has a membership of 10,000+ small businesses in the automotive services industry. Capricorn's national team of member relationship managers with a dedicated M2-Capricorn account management team has now begun active marketing of the specifically developed M2 Telecom service offering to Capricorn's members and its more than 1500 suppliers.

**Mobile wholesaling with Vodafone New Zealand**

M2's expansion in the New Zealand market continued following the launch of operations in Auckland early 2006. Of key significance was the execution of a mobile wholesaling agreement for New Zealand with Vodafone, the world's largest mobile telecommunications company.

This positions M2 amongst the first MVNO's in New Zealand, after the start of mobile number portability in April. On completion of certain technical steps by Vodafone, M2's New Zealand mobile service offering should be set for launch by the end of 2007.

**New acquisitions**

Having established a greater depth of management in M2 Telecom and M2 Wholesale, M2 searched for acquisitions with strategic fit and scale. Terms were agreed to acquire three businesses in May and June 2007.

(i) *Wholesale Communications Group (WCG);*

WCG builds on the product suite and capabilities of M2 Wholesale. WCG and its subsidiaries were acquired in May for a mix of cash and MTU shares. The maximum price (including performance based milestones) of \$3.3m represents a P/E multiple of 3.7 times WCG's 'run-rate' NPAT at the date of acquisition.

WCG is Australia's largest independent data services wholesaler, with over 250 customers (mainly ISPs) and a run-rate of revenue over \$16m and NPAT of \$0.8-1.0m.

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The senior management team and operational personnel of WCG have joined M2 and integration is complete, with a level of cultural and operational fit above expectations.

*(ii) Orion Telecommunications Limited*

In by far M2's largest acquisition, on 29 June M2 entered a Merger Implementation Agreement to acquire publicly listed Orion Telecommunications Limited (OTL) via a Scheme of Arrangement. Orion is an established full service telecoms services provider, trading under the Southern Cross Telco ("SCT") brand in Australia since 1994. SCT specialises in providing fixed, mobile and data services to small enterprise and regional markets Australia-wide, with over 25,000 customers and approximately \$30m in recurring annual revenues.

Orion is disposing of its Irish subsidiary and M2 will assume control of exclusively the Australian (SCT) operations, with the Orion publicly listed vehicle subsequently being deregistered.

The core operational personnel and management team of the SCT business, located in Hobart, will be retained and incorporated into M2 Telecom. SCT will add considerable back-of-house intellectual property and systems to M2, to provide a stronger, more scaled base of operations to support the next phase of growth for M2's small enterprise targeted business unit.

*(iii) Tenex Communications*

M2 acquired the customer base and business assets of Melbourne-based telecommunications service provider Tenex Pty Ltd on 30 June. The small enterprise customer base and operational assets cost \$510,000, paid by a mix of cash and Bartercard trade dollars.

Annualised revenues of Tenex were some \$1.6m, with an estimated NPAT contribution of \$250-300,000; on this basis the P/E multiple of the deal was under 2 times.

**Launch of M2 Online and [www.simplymobiles.com.au](http://www.simplymobiles.com.au)**

In July 2007 M2 launched its dedicated online business division, "M2 Online", with [www.simplymobiles.com.au](http://www.simplymobiles.com.au), an online mobile phone retail site offering a wide range of leading brand mobile phones and accessories.

Simply Mobiles offers "unbundled" mobile phone hardware at prices highly discounted to retail shops. It has become a leading online destination for mobile phones, receiving thousands of visitors a day with solid and growing sales, all effected online.

**Launch of Green Mobiles and [www.greenmobiles.com.au](http://www.greenmobiles.com.au)**

On 6 September M2 launched Australia's first environmental mobile telecommunications service, directly targeting climate change caused by global warming. Any customer can select Green Mobiles as their mobile service provider and M2 will contribute 10¢ in every dollar spent directly into the Australian Greenhouse Office (AGO) accredited carbon abatement programs via the Australian Climate Exchange [www.climateexchange.com.au](http://www.climateexchange.com.au) (ACX).

For example, in one year a typical \$49 Green Cap plan would offset nearly seven tones of carbon dioxide, based on the prevailing CO2 price of around \$8.50 per tonne – roughly offsetting emissions from two cars for a year, a household's electricity or a return flight to the USA. Green Mobiles offers a competitive choice of capped plans using Optus 3G. Sign-up, billing and queries are all online. Of course, prospective users can also readily acquire and recycle their mobile phones through Simply Mobiles!

Developing and running these online operations, Simply Mobiles and now Green Mobiles, has been a rapid learning curve for M2, placing it well for future initiatives in marketing and cost reduction as commerce, including for example telco-customer relations, moves online.

**Other potential revenue prospects**

Last year in reports we noted that M2 was reviewing prospects outside the telco field providing a customised virtual telco service to major corporates with a large customer base. Some of these opportunities have been developed, but look unlikely to impact FY08 and have been overtaken by the focus on strengthening and rapidly expanding M2's core activities by complementary acquisitions. One other income stream not mentioned above that may contribute in FY08 is licensing. Last year M2 licensed mobile telco sales & marketer E-Direct P/L, the Australian offshoot of a UK business generating over 3000 mobile phone connections a month in the UK. The license allows E-Direct to access M2's IP to assist the building of its Australian revenues. M2 is currently finalising discussions with one prospective NZ license partner and is progressing others in the Australian market, with potentially useful up-front and continuing fees and strategic connections.

**Summary**

Clients will observe how the various operations and acquisitions of M2 each complement and strengthen the other offerings of the group. We believe that, although still relatively small both as a listed company and in comparison with the 'tier-one' carriers, M2 is close to \$100m revenues this year and now has a depth and breadth of offerings across the telco field that, with its feel for marketing and focus on the bottom line, have lifted it to the next significant phase of its growth.

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