CCZ EQUITIES RESEARCH

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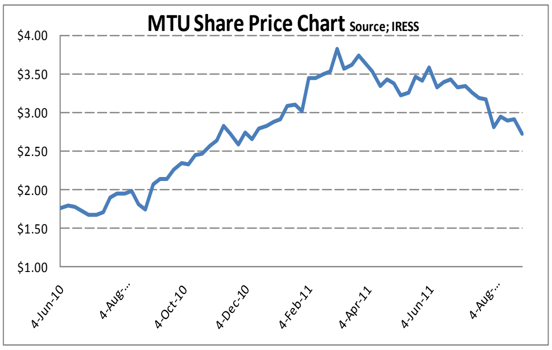
# M2 Telco (MTU); Re-investment in FY12, rewards in FY13-BUY

## Recommendation: BUY, target price $3.50

Share price: $2.86 | Market cap: $368m

| Year end June | 2010A | 2011A | 2012E | 2013E | 2014E |
|---|---|---|---|---|---|
| Revenue ($m) | 406.1 | 426.9 | 405.7 | 438.9 | 468.9 |
| EBITDA ($m) | 31.4 | 48.3 | 60.2 | 69.4 | 75.9 |
| EBIT ($m) | 26.1 | 41.9 | 52.9 | 61.9 | 71.8 |
| Net Profit ($m) | 16.1 | 28.3 | 36.1 | 43.0 | 50.4 |
| **EPS (cps)** | **16.7** | **26.1** | **31.4** | **36.9** | **39.9** |
| EPS growth | 72.7% | 56.8% | 20.4% | 17.4% | 8.1% |
| PER (x) | 17.2 | 10.9 | 9.1 | 7.7 | 7.2 |
| DPS (cps) | 10.0 | 16.0 | 19.5 | 23.2 | 27.2 |
| Yield (%) | 3.5% | 5.6% | 6.8% | 8.1% | 9.5% |




- **Management re-shuffling will lead founding CEO Vaughan Bowen to step into** an Executive Director position following the company's AGM in October, replaced by current COO, Geoff Horth. The announcement was a surprise, however, Vaughan Bowen will remain in a full time capacity, driving M2's agenda on corporate activity, strategic direction and positioning with suppliers ahead of an NBN.

- **FY11 results were within guidance range for EBITDA ($48.3m), NPAT ($31.3m) & EPS (25.3 cps).** Revenue of $427m fell 7% short of the guidance range mid-point, due to loss of the low margin $55m annualised E-Direct/VIP-Tel wholesale contract and once-off unprofitable mobile phone customer run-off within this business.

- **The ACCC issued final access determination (FAD) prices paid by M2** to Telstra applicable from July 2011. This contractually reduces the cost of wholesale line rental costs to $22.84 per month (from $26.93) and local call charges to 8.9c per call (from 17.36c). The likely windfall EBITDA cost savings delivered to M2 equate to $7.0m in FY11 and $13.8m in FY12, pre-discounting to customers.

- **Management provided FY12 guidance of midpoint EBITDA $60m (+24%),** including $5m-$10m worth of re-investment into reforming the sales channels, costs efficiencies and price competition. All three initiatives are funded by the wholesale price benefit and will likely lead to incremental market share gains and EPS accretion from FY13. Short term, these strategies represent hurdles to the M2 valuation rising above $3.00. The successful implementation of these initiatives during FY12 and evidence of returns in line with expectation, is likely to warrant a share price re-rating towards our **$3.50 price target. Initiate with a BUY recommendation.**

## Result Summary

| MTU result Brief $m | FY10a | FY11a | % change | Summary |
|---|---|---|---|---|
| Revenue | 406.1 | 426.8 | *5.1%* | lower margin revenue run off, acquisitions, organic growth of c6% |
| Retail division | 251.5 | 257.9 | *2.6%* | Unprofitable E-direct customers running off, organic growth is c6% |
| Wholesale division | 154.7 | 169.0 | *9.2%* | strong organinc fixed line & data customer growth, offsetting the loss of $20m VIP-Tel/ e-direct pass through contracts during FY11 |
| EBITDA | 31.4 | 48.3 | *53.7%* | c$7.0m EBITDA uplift from the ACCC benefit, cost savings, improved People & Commander performance |
| EBITDA % margin | 7.7% | 11.3% | *3.6%* | margin accretion, expect overall margins trending to c15% during FY12 |
| **Operating results** | **FY10a** | **FY11a** | **% change** | **Summary** |
| Employee expense % revenue | 9.7% | 8.9% | *-0.8%* | cost synergies have crystallised and scale is increasing, expect more billing system savings by FY13 |
| Tax rate | 33.2% | 31.1% | *-2.1%* | >30% due to tax adjustment for non-temporary differences |
| EPS adj % change | 16.7 | 26.1 | *56.8%* | excellent conversion of EBITDA growth to EPS, in line with guidance |
| Working Capital increase (decrease) | 5.0 | -7.8 | *-258%* | Accrued payables fell by $9.1m, partially reflecting the ACCC wholesale supply benefit and less monthly outflow to Telstra. |
| **Cash & Balance Sheet** | **FY10a** | **FY11a** | **% change** | **Summary** |
| Operating Cash /EBITDA | 42.4% | 82.4% | *40.0%* | Improved cash conversion during FY11, $5m tax outflow has been delayed to early FY12 |
| DPS payout (adj EPS) | 68.9% | 69.3% | *0.4%* | Steady payout ratio on adjusted EPS, 100% franking, strong yield |
| Net debt (cash) /equity % | -4.7% | 5.0% | *9.7%* | debt funded Clear Telecoms acquisition, overall conservative balance sheet, M2 is on track for zero net debt during FY12 |

*Source; CCZ Equities,Company Report*

## Result Highlights

- **The total $16.9m increase in FY11 EBITDA can** be split between <u>$4.0m acquisitions</u> (Clear, Austar, Bell, e-direct, Black & White group for 3-6 months), <u>$7.0m wholesale supply benefit</u> and <u>$5.9m organic growth from Clever, Commander, People & M2</u>. Organic performance is a key positive in the result.

- **Margins have turned a corner and are heading north of 15% -** Group wide EBITDA margins improved to 11.3% from 7.7% during FY11. Driven by a full year's benefits of the ACCC Wholesale pricing change, cost synergies from recent acquisitions (Clear, Bell, Austar), organic growth and billing system cost efficiencies, EBITDA margins are likely to expand to 14.8% during FY12 and then to 15.8% during FY13. We assume that all re-investment costs are taken above the line and included in EBITDA.

- **The wholesale division's revenue grew by 9% and the changing mix of revenues has had a positive influence on margins.** As part of the recent asset acquisition of former customer E-Direct/VIP-Tel, MTU has forgone a $55m annualised wholesale "pass-through" revenue contract, reducing wholesale divisional revenue by likely $9.1m in FY11. The contract was at a very low 1.5% margin (c$0.8m EBITDA) and therefore, the margin mix within the wholesale- ISP division improved to 5.6% (from 3.8% pcp). Organic growth of an estimated 15.6% was an upside surprise to performance within the wholesale division, driven by increased fixed line and wholesale broadband customer sales.

- **Revenue within the retail division grew by 5%,** with estimated organic revenue growth of c9% within the People and Commander business, likely offset by lower margin E-Direct/VIP-Tel customers being run off the books and $1.5m worth of past due receivables written down. MTU now markets directly to VIP-Tel's c42,000 customer base through the retail division and we estimate that around 5,000 low grade, past due customers have been churned off the customer base. EBITDA margins within the retail division rose to 15.0% from 10.1%, providing a leading indicator for group wide margins into FY12.

## M2 Telecommunications Overview

**M2 Telecommunications Group is a re-seller of fixed line, mobile and data services to small businesses and wholesale ISP customers.** M2 has grown organically and by acquisition since establishment in 1999. Key brands include People Telecom, Commander, M2 Telecom & Southern Cross. M2 is the largest fixed line customer of Telstra. The retail division accounts for 78% of EBITDA, with the remainder captured with the wholesale division. M2 employs over 450 people in offices through major Australian cities & NZ.

**M2 services an estimated 110,000 retail customers across the brands, giving the company a c6% domestic share of the SME market.** The product split, by revenue is estimated 70% fixed line, 15% mobile and 15% data and broadband services. Sales are generated through a mix of dedicated internal "inside sales" staff, dedicated sales teams and specialised dealer groups based on more of a commission structure through the Commander and People Telecom brands. An estimated 30% of sales are booked by the inside sales team. Customer churn rates are low by industry standards. The bulk of new customers stem from churn off Telstra, whom is also the main supplier of fixed line phone infrastructure. M2 can be view as a path to market for Telstra, as well as a competitor.

| M2 Telecom; brands | Target market | Core Proposition | Path to Market |
|---|---|---|---|
| Commander | SME | Personalised service, telecom services often partnered with equipment | National Exclusive dealer and agent network. Sales channels to be ramped up during FY12. |
| People Telecom | SME | Personalised Services & tailored offerings | National dealer network & sales channels |
| Southern Cross Telco | SME, consumer & SOHO | Regional focus with personalised service | Direct & selected dealer network |
| M2 Telecom | SME | Loyalty programs & associated alliances with personalised service | Specialist dealer network |
| Clear Telecom | SME | Telecom services often partnered with equipment | Direct & selected dealer network. Smaller than commander and people. |

*Source; Company Reports, CCZ Equities*

## Senior Management Team

| Senior Management | Position with M2 | Summary |
|---|---|---|
| Mr. Vaughan Bowen | CEO* & Board member | Founding CEO of M2 in 2000. |
| Mr. Geoff Horth | COO* | M2 executive committe, Operations Manager. General Manager of Commander prior to M2 acquisition |
| Mr. Darryl Inns | CFO | Group CFO, |
| Mr Craig Farrow | Chairman | Founder Brentnalls SA, CA, Director since '00 |
| Mr. Steve Wicks | Group Sales Director | Sales manager, long run M2 executive. |

Source; CCZ Summary Company Reports * Vaughan Bowen to move into Executive Director Role Oct'11

## M2 Telecommunications (MTU.AX)

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Publication Date: 5 Sep 2011

| STOCK INFORMATION | Share Price (AUD) | $ 2.86 | Market Cap (AUD) | 368.4m |
|---|---|---|---|---|
| M2 Telecommunications Group is a re-seller of fixed line, mobile and data services to small businesses and wholesale ISP customers. M2 has grown organically and by acquisition since establishment in 1999. Key brands include People Telecom, Commander, M2 Telecom. M2 is the largest fixed line customer of Telstra. The retail division accounts for 78% of EBITDA. M2 employs over 450 people in offices through Aus & NZ. | **Target Price (AUD)** | $ 3.50 | Shares on Issue | 128.8m |
| | **Recommendation** | **BUY** | Year End | 30-Jun |
| | 1yr TSR Potential | 29.1% | | |

| RETURN ANALYSIS | 2010A | 2011A | 2012E | 2013E | 2014E |
|---|---|---|---|---|---|
| **Underlying EPS (AUD cps)** | **16.7** | **26.1** | **31.4** | **36.9** | **39.9** |
| Growth | 72.7% | 56.8% | 20.4% | 17.4% | 8.1% |
| Shares on Issue (m) | 113.9 | 128.8 | 128.8 | 128.8 | 128.8 |
| **PE** | **17.2x** | **10.9x** | **9.1x** | **7.7x** | **7.2x** |
| PE - Market | 15.0x | 14.3x | 12.2x | 11.2x | 10.3x |
| PE Relative | 14.5% | (23.4%) | (25.5%) | (30.8%) | (30.5%) |
| Dividend (AUD cps) | 10.00 | 16.00 | 19.50 | 23.24 | 27.23 |
| Franking | 100.0% | 100.0% | 100.0% | 100.0% | 100.0% |
| **Dividend Yield** | **3.5%** | **5.6%** | **6.8%** | **8.1%** | **9.5%** |
| Payout Ratio (on adj EPS) | 60.0% | 61.2% | 62.0% | 63.0% | 68.2% |
| **EV/EBITDA** | **11.8x** | **8.0x** | **6.3x** | **5.1x** | **4.4x** |
| **EV/EBIT** | **14.2x** | **9.2x** | **7.1x** | **5.7x** | **4.6x** |
| EBITDA/Sales | 7.7% | 11.3% | 14.8% | 15.8% | 16.2% |
| EBIT/Sales | 6.4% | 9.8% | 13.0% | 14.1% | 15.3% |
| ROE | 20.9% | 30.2% | 33.0% | 34.2% | 34.9% |
| ROFE | 38.2% | 44.3% | 46.4% | 54.0% | 64.9% |

### VALUATION SUMMARY

| **Models (AUD/share)** | | **DCF - Key Inputs** | | **DDM - Key Inputs** | |
|---|---|---|---|---|---|
| DCF | 4.01 | WACC | 12.5% | Retention Ratio | 38.0% |
| DDM | 2.98 | Cost of Equity | 12.5% | Expected Growth | 16.1% |
| PE | 3.84 | | | | |
| **Weighted Avg** | **3.50** | | | | |

| **Valuation Weighting** | |
|---|---|
| DCF | 50.0% |
| DDM | 50.0% |
| PE | 0.0% |

| **PE - Key Inputs** | 2012E | 2013E | 2014E |
|---|---|---|---|
| Target PER relative | 90.0% | 90.0% | 90.0% |
| Discount Rate | 91.6% | 87.3% | 83.2% |
| PV of EPS | 3.65 | 3.85 | 3.83 |
| PV of Dividend | 0.19 | 0.21 | 0.24 |
| PE Valuation | 3.84 | 4.07 | 4.07 |

| PROFIT & LOSS (AUD'm) | 2010A | 2011A | 2012E | 2013E | 2014E |
|---|---|---|---|---|---|
| **Revenue** | **406.1** | **426.9** | **405.7** | **438.9** | **468.9** |
| Operating Cost | (374.7) | (378.6) | (345.6) | (369.6) | (393.0) |
| **EBITDA** | **31.4** | **48.3** | **60.2** | **69.4** | **75.9** |
| Depreciation | (1.5) | (1.4) | (1.4) | (1.6) | (1.8) |
| **EBIT** | **26.1** | **41.9** | **52.9** | **61.9** | **71.8** |
| Net Interest | (2.0) | (0.9) | (1.2) | (0.3) | 0.3 |
| **Pre-Tax Profit** | **24.1** | **41.1** | **51.7** | **61.6** | **72.1** |
| Other Significants | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Tax | (8.0) | (12.8) | (15.6) | (18.6) | (21.7) |
| **Reported NPAT** | **16.1** | **28.3** | **36.1** | **43.0** | **50.4** |
| **Underlying NPAT** | **18.5** | **32.0** | **39.8** | **46.7** | **50.5** |
| *Income Growth* | *100.6%* | *5.1%* | *(4.9%)* | *8.2%* | *6.8%* |
| *EBITDA Growth* | *140.2%* | *53.7%* | *24.7%* | *15.3%* | *9.4%* |
| *EBIT Growth* | *137.7%* | *60.7%* | *26.1%* | *17.0%* | *16.0%* |
| *Underlying PBT Growth* | *129.2%* | *70.4%* | *25.9%* | *19.1%* | *17.1%* |
| *Reported NPAT Growth* | *115.3%* | *75.8%* | *27.6%* | *19.2%* | *17.2%* |

| BALANCE SHEET (AUD'm) | 2010A | 2011A | 2012E | 2013E | 2014E |
|---|---|---|---|---|---|
| Cash | 15.1 | 12.5 | 7.0 | 18.4 | 39.9 |
| Receivables | 55.8 | 51.1 | 48.6 | 52.6 | 56.2 |
| Inventory | 0.3 | 0.4 | 0.3 | 0.4 | 0.4 |
| Other | 7.6 | 11.2 | 11.2 | 11.2 | 11.3 |
| **Current assets** | **78.5** | **74.9** | **66.8** | **82.3** | **107.4** |
| Fixed Assets | 3.7 | 3.4 | 3.5 | 3.4 | 3.1 |
| Intangibles | 70.3 | 116.6 | 120.9 | 115.3 | 113.4 |
| Other | 6.8 | 6.4 | 6.4 | 6.4 | 6.4 |
| **Non-Current Assets** | **80.8** | **126.5** | **130.8** | **125.1** | **122.8** |
| **Total Assets** | **159.3** | **201.4** | **197.7** | **207.4** | **230.2** |
| Creditors | 54.2 | 57.5 | 54.6 | 59.1 | 63.1 |
| Short term debt | 5.1 | 12.5 | 12.5 | 12.5 | 12.5 |
| Current tax liability | 3.1 | 3.7 | 2.7 | 1.7 | 1.7 |
| Other | 3.9 | 11.6 | 11.6 | 11.6 | 11.6 |
| **Current Liabilities** | **66.3** | **85.2** | **81.4** | **84.8** | **88.9** |
| Long term debt | 11.4 | 17.3 | 2.3 | (7.7) | (7.7) |
| Other term liabilities | 4.4 | 5.1 | 5.1 | 5.1 | 5.1 |
| **Total Liabilities** | **82.2** | **107.6** | **88.8** | **82.2** | **86.3** |
| **Total Shareholder Funds** | **77.1** | **93.8** | **108.9** | **125.2** | **144.0** |
| Total Funds Employed | 73.5 | 98.5 | 104.1 | 99.0 | 96.3 |
| **Liquidity and leverage ratios** | | | | | |
| P/Book ratio | 4.1 | 3.7 | 3.3 | 2.9 | 2.5 |
| NTA per Share | 0.20 | (0.00) | (0.04) | 0.06 | 0.22 |
| Net Debt / Equity | (18.3%) | (10.4%) | (4.1%) | (15.5%) | (36.2%) |
| Net Debt / Market Value | (3.3%) | (2.5%) | (1.0%) | (3.9%) | 100.0% |
| EBITDA Interest Cover | 15.8x | 55.8x | 51.3x | 239.4x | (224.9x) |
| Net Debt / EBITDA | (0.4x) | (0.2x) | (0.1x) | (0.2x) | (0.5x) |
| Discount Val of franking cr $m | 2.4 | 4.2 | 4.7 | 5.0 | 5.2 |

| CASHFLOW (AUD'm) | 2010A | 2011A | 2012E | 2013E | 2014E |
|---|---|---|---|---|---|
| **Gross Cash Flow** | **31.8** | **51.1** | **62.7** | **72.8** | **76.3** |
| Change in Working Capital | 5.0 | (7.8) | 0.3 | (0.5) | (0.4) |
| Net Capital Expenditure | (0.9) | (1.2) | (1.5) | (1.5) | (1.5) |
| **Free Cash Flow** | **35.9** | **42.1** | **61.5** | **70.8** | **74.4** |
| **Free CFPS (AUD cps)** | **31.5** | **32.7** | **47.7** | **55.0** | **57.8** |
| Price / Free CFPS | 11.1x | 10.7x | 7.3x | 6.4x | 6.1x |
| Capex / Depreciation | 0.6x | 0.8x | 1.0x | 0.9x | 0.8x |

| SEGMENT INFORMATION | 2010A | 2011A | 2012E | 2013E | 2014E |
|---|---|---|---|---|---|
| **Retail (SME customers)** | | | | | |
| Revenue (AUD'm) | **251.5** | **257.9** | **282.4** | **310.6** | **335.5** |
| Growth | 124.4% | 2.6% | 9.5% | 10.0% | 8.0% |
| **Wholesale (ISP customers)** | | | | | |
| Revenue (AUD'm) | **154.7** | **169.0** | **123.3** | **128.3** | **133.4** |
| Growth | 72% | 9% | -27% | 4% | 4% |
| **Sector Contribution (EBITDA)** | | | | | |
| Retail SME's | 81.2% | 80.2% | 84.0% | 84.6% | 84.9% |
| Wholesale ISP's | 18.8% | 19.8% | 16.0% | 15.4% | 15.1% |

**SUBSTANTIAL SHAREHOLDERS**

| Shareholder | Holding | Last Notice |
|---|---|---|
| 1. Hunter Hall Investment Management | 10.1% | 25-Mar-11 |
| 2. Cornish Group Investments | 8.3% | 3-Mar-11 |
| 3. Vaughan Bowen | 6.8% | 7-Apr-11 |
| 4. NAB Nominees (Pengana) | 7.0% | 23-Aug-10 |

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