Lodge Partners Research
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BUY - $1.50

M2 Telecommunications (MTU)

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Defensive recurring cashflow model

Company Data

ASX Code	MTU
Price	$1.50
12 month price target	$1.95
12 month dividend yield	8.0%
Implied return	38%
Shares on issue	110m
Market capitalisation	$164.5m
12 Month price range	$0.43/$1.59
Monthly turnover	2.8m

Earnings Summary

Yr to 30 Jun	2009	2010F	2011F	2012F
Lodge adj profit	8.1	24.2	26.0	27.3
Rep. Profit (pre-sig)	7.5	19.2	21.0	22.3
EPS (¢)*	9.6	22.1	23.6	24.8
EPS growth	**26.6%**	**97.0%**	**9.1%**	**6.0%**
P/E ratio	**15.5 x**	**6.8 x**	**6.3 x**	**6.0 x**
DPS (¢)	5.5	12.0	13.5	14.0
Yield	**3.7%**	**8.0%**	**9.0%**	**9.4%**
Franking	100%	100%	100%	100%
Payout ratio	62%	69%	71%	69%
EV / EBIT	15.7 x	5.9 x	5.4 x	4.8 x
EV / EBITDA	13.2 x	4.7 x	4.5 x	4.0 x
CFPS (¢)	9.9	24.7	21.3	27.2
Price / CF	15.1 x	6.0 x	7.0 x	5.5 x
NTA per share	-$0.20	-$0.15	-$0.09	$0.02
Pr / NTA	-7.4 x	-9.7 x	-17.1 x	64.3 x

Share Price Chart

Source: Iress Market Technology

Over the past few years, M2 Telecommunications (MTU) has grown both organically and through acquisitions to become the largest telecommunications reseller in Australia by revenues. MTU resells a broad range of fixed line, mobile and data products from Telstra, Optus and Vodafone direct to a retail base through the M2 Retail division, which incorporates the People Telecom, Commander and Southern Cross Telco brands. In addition, MTU resells telco services to a wholesale base through the M2 Wholesale division, which targets smaller telcos and ISPs.

MTU's strategy is to target the SME market: MTU's competitive differentiation in the market is around personalised customer service, timely technical support and tailored product bundles, which appeal to the SME market. MTU targets the SME market directly through the retail channel and indirectly through its wholesale operations.

Full year impact of recent acquisitions: In FY10, MTU will benefit from the full year impact of the People Telecom and Commander businesses, which were acquired in 2HY09. We forecast total revenue will increase from $202m in FY09 to $410m in FY10. These two acquisitions increased MTU's share of the SME market and provided MTU with access to a national dealer network with strong existing relationships with SMEs in local markets. The medium term opportunity is to cross-sell additional telco products across the combined customer base in order to drive earnings and increase customer loyalty.

Favourable earnings impact from supplier contract negotiations: MTU is currently in the process of renegotiating its supply contracts with its major suppliers of both fixed line and mobile services. We expect the new commercial arrangements to reflect MTU's increased scale (through the People Telecom and Commander acquisitions) and its role as a major wholesale customer. Although the outcome of these negotiations remains unclear, our earnings forecasts include volume discounts on access services rental and carriage due to MTU's increased scale.

Initiate coverage of MTU with a Price Target of $1.95 and a BUY recommendation: We believe that MTU generates a quality earnings stream across a diversified customer base, with a positive working capital cycle, low gearing and minimal infrastructure requirements. We expect that FY10 will be a year of internal consolidation for MTU in order to effectively integrate previous acquisitions and that there are opportunities for solid organic growth over the medium term through increased market share, product cross-selling, operational synergies and increased bargaining power with suppliers.

Key short term catalysts for MTU are: 1) the conclusion of contract negotiations with key suppliers which incorporate volume discounts; 2) evidence that the restructure of the Commander dealer network is generating stronger sales and cross-selling; and 3) operating synergies from economies of scale and streamlining processes.

Our 12 month Price Target of $1.95 implies an FY10 PE multiple of 8.8x on adjusted EPS of 22.1cps and an FY10 PE of 11.1x on reported EPS of 17.5cps. We consider these multiples undemanding given the defensive earnings stream and strong organic growth potential over the medium term.

Valuation: $1.95 per share, a 30% premium to market

We value MTU using a blended DCF and earnings capitalisation valuation methodology.

DCF Valuation Methodology - Base Case

We believe that MTU generates a good quality earnings stream which can be characterised as follows:

MTU generates a quality earnings stream from recurring defensive cashflows

- Defensive recurring revenue stream with a diversified customer base across both retail and wholesale channels
- Strong cashflow generation with a positive working capital cycle
- Low infrastructure and capex requirements
- Conservative gearing with debt reduction strategy
- Favourable regulatory changes which will lower the cost base

Our base case earnings forecasts include the following key assumptions:

MTU's FY10 earnings will structurally increase due to two major acquisitions in 2HY09

1. The full year impact of the People Telecom and Commander acquisitions will structurally increase MTU revenue and earnings in FY10;
2. Finalisation of new supply contracts with key suppliers which incorporate volume discounts on the increased scale of MTU business;
3. The cross-selling of fixed line, mobile and data products across both the Retail and Wholesale customer bases will sustain organic growth rates of at least 5% in FY11 and FY12; and
4. Continued internal operating efficiencies over the medium term.

Figure 1. FCFF Summary

Summary			Comment
Firm Value	$m	223.8	• WACC 13.0% (Ke: 13.5%, Rf: 6%, TVg: 3%)
Less Net Debt	$m	(9.6)	• Net debt $9.6 and total debt of $16.3 in FY09
Equity Value	$m	214.2	
No Shares	m	110.1	• 38% increase in shares on issue in FY09
Value Per Share	$	**1.95**	• DCF value per share of $1.95
Premium to current price	%	30%	
12 month dividend yield	%	8.0%	• 70% payout ratio policy on reported EPS
Total Return	%	38%	

Source: Lodge Estimates

We value MTU at $1.95 using a DCF valuation and a WACC of 13%

In our DCF valuation we use a WACC of 13.0%, which we believe reflects the defensive recurring cash earnings stream but also acknowledges the execution risk in integrating previous acquisitions and managing the larger enterprise.

Figure 2. Sensitivity of price target to WACC

		Cost of Capital (WACC)				
	1.95	**14.0%**	**13.5%**	**13.0%**	**12.5%**	**12.0%**
TV_g	**4.0%**	1.82	1.93	2.06	2.20	2.36
	3.5%	1.78	1.89	2.01	2.14	2.29
	3.0%	1.75	1.85	1.95	2.08	2.22
	2.5%	1.71	1.81	1.92	2.04	2.17
	2.0%	1.68	1.78	1.88	1.99	2.11

Source: Lodge Estimates

Our DCF valuation of $1.95 implies an FY10 PE multiple of 8.8x on EPS

Our DCF valuation of $1.95 can be reconciled with an FY10 PE multiple of 8.8x on our FY10 EPS_{adj} of 22.1cps (which is adjusted to add back the $5m contract amortisation expense) and an FY10 PE multiple of 11.1x based on reported EPS of 17.5cps. We consider these multiples to be undemanding given the defensive, recurring cashflow which is generated from a diversified customer base with strong organic growth potential over the medium term.

Telecommunications Network Reseller

MTU provides a broad range of telecommunication services to both retail and wholesale customers through a Network Reseller model.

MTU is the largest telco reseller in Australia

Figure 3. Australian Telecommunications Services Industry

Tier 1	Tier 2	Tier 3
Network Owners	Partial Network Owners	Network Resellers
Full Network Infrastructure	Partial Network Infrastructure	No Network Infrastructure
Eg. Telstra, Optus, Vodafone	Eg. iiNet, Pipe Networks	**Eg. M2 Telecommunications**

Source: MTU 2008 Annual Report and Lodge Estimates

- MTU sources its telco services from Tier 1 suppliers including Telstra, Optus and Vodafone;
- MTU has minimal network infrastructure which enables the company to operate a low capex model; and
- MTU is able to resell the best of breed telecommunications products from the Tier 1 suppliers.

MTU's Acquisition History

MTU has grown organically and through acquisition

Over the past few years MTU has established a record of consistent earnings growth both organically and through acquisitions. The recent acquisitions of People Telecom and the telecoms assets of Commander in 2HY09 have consolidated MTU's position as the largest telco reseller in Australia.

The two major acquisitions in 2HY09 were People Telecom and Commander

Figure 4. Acquisition history of MTU

Company	Date Acquired	Price	Comments
Wholesale Communications (WCG)	May 2007	$1.4m	• Paid $0.9m in cash and $0.5m in equity • Increased exposure to wholesale data services • Recurring revenue at acquisition of ~$10m
Orion Telecommunications (ASX Listed - OTL)	Sep 2007	$21.8m	• Paid $6.7m in cash and $15.1m in equity • Southern Cross Telco brand • Target markets - SME, SOHO, residential, regional • Contact centre in Hobart • Recurring revenue at acquisition of ~$25m
Unitel Australia (Acquired from ASX Listed Commander - CDR)	Feb 2008	$10.6m	• Paid $10.6m in cash • Increased exposure to wholesale fixed line services • Recurring revenue at acquisition of ~$35m
People Telecom (ASX Listed - PEO)	Apr 2009	~$19m	• Paid $2m in cash and $17m in equity • Recurring revenue at acquisition of ~$80m • Target market of SME customers • Increased Sydney footprint
Commander (ASX Listed - CDR)	Jun 2009	~$19m	• Paid $19m in cash (including deferred payments) and stock • Acquired the telecoms assets including the 'Commander' brand, customer contracts, all operating systems and the 'OneStream' data network • Target market of SME customers and small corporate • Recurring revenue at acquisition of $110m • Purchased from receivers

Source: Lodge Estimates

MTU's Strategy

MTU's strategy is to target the SME market

MTU's strategy is to:

1. **Target the niche SME market:** MTU's strategy is to be the preferred telco supplier to the SME market. The MTU brands are positioned around a 'value for money' offering which incorporates personalised customer service, dedicated account management, technical support and tailored product bundles. The major telcos use their economies of scale and strong branding to target the corporate/government clients and the consumer/residential market. As a consequence, the SME market is generally not well served by the major telcos, which creates an opportunity for a specialised telco, such as MTU, to serve this market with its unique offering.

Increase operating leverage both internally and externally

2. **Maximise operating leverage:** MTU's recent acquisitions have consolidated its position as the largest telco reseller in Australia and MTU's strategy is now to maximise the operating leverage both internally and externally. Internally, MTU is consolidating its systems, integrating previous acquisitions and improving operating efficiencies. Externally, MTU is using its stronger buying power to negotiate improved volume discounts from major suppliers and increase its brand awareness and sales channel reach within the SME market.

And to cross sell a full range of telco services to the combined customer base

3. **Cross-sell telco services:** Over the past few years, MTU has made several acquisitions in both the Retail and Wholesale divisions and MTU's strategy is now to cross sell a broader product range, including fixed line, data and mobile, to the larger customer base. MTU is strengthening its sales and service channels by providing incentives for its sales team to meet performance targets which include increasing the number of services per customer.

Divisional Analysis

MTU has two key divisions:

- M2 Retail; and
- M2 Wholesale

M2 Retail

M2 operates several retail brands which directly target SMEs

The M2 Retail division offers fixed line, data and mobile services direct to the SME market under a variety of brands including Commander, People Telecom, M2 Telecom and Southern Cross Telco. In addition, MTU operates two online retail brands, Simply Mobiles and Green Mobiles. Each brand has a slightly different value proposition and sales channel.

Figure 5. M2 Retail brand positioning

M2 Retail Brand	Target Market	Core Proposition	Path to Market
Commander	SMB and small corporates	Telecom services bundled with telecom equipment	National exclusive dealer network
People Telecom	SMB	Personalised service and tailored offerings	National dealer network
M2 Telecom	SMB	Loyalty Programs and association alliances	Specialist dealer network
Southern Cross Telco	SMB and residential	Regional focus	Direct and selected dealer network

Source: MTU 2009 Annual Report pg.11

We forecast the retail division will generate $270m in revenue in FY10, up 265% on pcp

Over the past three years, the M2 Retail division has demonstrated strong growth with revenue increasing from $33m in FY07 to a forecast $270m in FY10. This growth has been driven both organically and through key acquisitions such as Orion (Southern Cross Telco), People Telecom and Commander. M2 Retail now has over 100K customers nationally across the SME, residential and regional markets.

M2 Retail offers a range of fixed line, data and mobile services to SMEs. MTU's strategy is to enter the SME with a fixed line product, as the traditional phone line remains a core requirement of most SME business operations and the expenditure on fixed line carriage accounts for the majority of telco spend for an SME. In FY09, fixed line products were the major revenue driver in the M2 Retail division accounting for over 70% of revenue.

The mobile and data products each account for around 15% of total revenue and MTU is focused on cross-selling these products across the SME customer base in order to increase customer loyalty and lower the churn rate.

Commander Acquisition

The Commander acquisition was strategically important for MTU as it provided access to:

The Commander acq was strategically important for MTU

- **A trusted SME brand:** SME clients often want a trusted local telco services advisor, who offers personalised service and can take responsibility for fixing any issues or service disruptions on a timely basis. Commander had long history of providing telco and phone hardware systems to SMEs nationally and this brand remains strong in the market. The Commander acquisition added ~30K SME clients to MTU's customer base which consolidated MTU's position as a major provider of telco services to the SME market.
- **A national dealer network:** The Commander acquisition gave MTU a national network of 36 exclusive dealers that have strong existing relationships with SMEs in the local market in each territory. Post acquisition, MTU has restructured the Commander business from a franchise model to a territory dealership model. Under this new model, the dealers work exclusively with MTU approved products and services. In addition, the dealers have to hit certain performance criteria and sales targets in order to retain their Commander dealership.

MTU acts as an intermediary between the dealer and the financing company

Figure 6. Relationship between MTU and Commander dealerships

SME Product	Commander Dealership	MTU	Financing Company
SME orders a Phone System for the office <u>with financing</u>	Dealer installs phone system hardware on a 3-5 year financing arrangement Client pays monthly repayment to MTU Dealer receives a percentage of clients monthly spend from MTU to provide maintenance services to clients	MTU acts as intermediary bw dealer and financing company When financing contract has been repaid, MTU keeps collecting the client's monthly repayment whilst the customer retains the phone system. <u>This is MTU's inertia rental revenue stream.</u>	Finance company provides financing for phone system hardware over 3-5 years
SME orders a Phone System for the office <u>with no financing</u>	Same as above – it makes no difference to the dealer whether or not the client uses financing	MTU does not play a significant role in these transactions	No involvement by financing company
SME purchases telco carriage services for the office	Dealer cross-sells fixed line, mobile and data carriage into SME clients Dealer receives an upfront sales commission plus ongoing monthly trailing fee for fixed line sales	MTU provides wholesale telco carriage services to SME client	No involvement by financing company

Source: Lodge Partners

The above table shows that the Commander acquisition provides MTU with two major earnings streams:

MTU generates revenue through the inertia rental stream and the cross-selling of telco carriage services

- <u>The inertia rental stream</u> – When the client orders a phone system with financing through a Commander dealer, the client pays a monthly fee over 3-5 years, which includes the repayment of the financing component and a maintenance fee component. When the financing component has been repaid, the client on average keeps paying the same monthly fee to MTU (through inertia) for an additional 1-3 years in order to maintain the use of the phone system and retain the maintenance services component. This creates a high margin revenue stream for MTU over the inertia period. This inertia rental stream will continue to increase in line with growth in new phone system financing contracts.
- <u>The telco carriage services cross-sell</u> – Currently less than 20% of the Commander SME client base buy carriage services through MTU, so there is significant potential for the cross-selling of these services into the existing client base. The sale of carriage into the Commander SME base is a win-win for both MTU and the Commander dealers. For MTU, it increases the volume of its carriage through the major telcos, which is a key driver of revenue and earnings. For the Commander dealers, the sale of carriage increases their top line via commissions received from MTU, with minimal increase in overheads thus improving dealer's profitability.

People Telecom acquisition

People Telecom increased MTU's SME customer base and increased geographic diversity

The People Telecom acquisition gave MTU access to:

- **A telco challenger brand:** People Telecom was positioned as an alternative provider of telco services for SMEs that were looking for options outside of the major telcos;
- **Additional penetration in the SME market in Sydney:** People Telecom had about 30K SME clients, which MTU can now use to cross-sell a broader bundle of telco services including bundled mobile and voice. This acquisition increased MTU's national footprint with increased penetration in the Sydney market.

M2 Retail Divisional Forecasts

Our key assumptions are as follows:

The full year impact of acquisitions will boost FY10 earnings

- The structural increase in revenue and EBITDA in FY10 is due to the annualised impact of both the Commander and People Telecom acquisitions.
- In FY10, we assume the Commander acquisition contributes $120m in revenue and $12m in EBITDA, which implies EBITDA margins of 10%. We assume that the inertia rental stream accounts for between one third and a half of Commander EBITDA.
- In FY10, we assume the People Telecom acquisition contributes $80m in revenue and $6m in EBITDA, which implies EBITDA margins of 7.5%. We assume that MTU extracts $2-3m of savings at the EBITDA level through improved operating efficiencies and duplication in back office functions and shares services in HR, finance and general administration.

Over the medium term, we expect organic growth through cross-selling and access to volume discounts through increased scale

- The major operating expense for the M2 Retail division is the cost of wholesale network carriage from Telstra, Optus and Vodafone, which generally accounts for around 75-80% of revenue. MTU provides an aggregated 'Cost of Sale' expense for the consolidated entity but does not give a detailed network expense breakdown per division or per product.
- We expect that the increased scale of the M2 Retail division, through recent acquisitions, will provide MTU with increased bargaining power with its wholesale suppliers and increased access to volume discounts. We believe that there is sufficient competitive tension between the two major suppliers to ensure that negotiations remain commercially competitive over the medium term.
- In FY10 we forecast EBITDA margins of 9%, up from 6.3% in FY09, due to short term operational synergies from acquisitions and an improved cost of sale. We do not factor in significant upside from cross-selling products in FY10. However we believe that the restructure of the Commander dealership network, the alignment of the dealer's incentives with MTU's profitability, and the reinvigoration of its sales channels will sustain organic growth rates over the next few years.

We forecast 5% organic growth and 9% EBITDA margins over the medium term

- In FY11 and FY12, we forecast of 5% revenue growth and EBITDA margins stabilising at 9%. We believe that the key drivers of growth will be increased sales of fixed line carriage and 3G mobile products into the combined SME customer base and the longer term synergies of economies of scale in internal operations.

Figure 7. Earnings forecasts for M2 Retail

	FY08	FY09	FY10F	FY11F	FY12F
Revenue	39	74	270	284	298
Revenue Growth		*90%*	*270%*	*5%*	*5%*
EBITDA	5.3	4.7	24.3	25.5	26.8
EBITDA Margin	*13.7%*	*6.3%*	*9.0%*	*9.0%*	*9.0%*

Source: Lodge Estimates

M2 Wholesale

The M2 Wholesale division offers a full range of telecommunication services including fixed line, mobile and data to the reseller market. This division was established in 2006 and has scaled up over the past 3 years through the acquisition of Wholesale Communications Group (May 2007) and Unitel Australia (Feb 2008). The M2 Wholesale division is run as a standalone unit with clear operational separation from the M2 Retail division.

M2 Wholesale provides telco services to junior telcos and ISPs, for them to sell to their own retail client base

The key target market for the M2 Wholesale division is junior telcos or Internet Service Providers (ISPs) that resell telecommunications services to their own retail client base. In Australia, there are ~500 small telcos and ISPs, primarily targeting specific regional, industry or demographic markets. MTU supplies wholesale telco services to about half of these smaller telcos. Similar to the M2 Retail division, this target market often requires customised product bundles, a high level of technical support and dedicated account management and again this market is often not a priority for the major telcos.

In FY09, M2 Wholesale generated $128m in revenue (up 83% on pcp), which reflected the full year contribution of previous acquisitions. Similar to the M2 Retail division, the fixed line is the major revenue driver, accounting for over 60% of revenue in FY10. Although this is a legacy product, the fixed line carriage remains a core operating necessity for MTU's customer's customer at the retail level (which is usually an SME).

M2 Wholesale Divisional Forecasts

Our key assumptions are as follows:

- In FY10, we assume that the M2 Wholesale division generates $140m in revenue, which is up 9.4% on pcp.

The gross margins are lower in wholesale than retail but the operating expenses are also lower thus resulting in similar EBITDA margins

- The gross margins are lower in the M2 Wholesale division, relative to the M2 Retail division, which reflects greater volume discounts passed onto wholesale customers. However the wholesale division also has lower operating expenses and overheads relative to the retail division. Therefore the operating EBITDA margins are similar across both the wholesale and retail division at between 8-9%.
- In FY10, we assume that the M2 Wholesale division generates similar EBITDA margins on pcp as there have been no major changes to this division over the past year. Wholesale customers tend to be very sticky, due to the relatively high barriers to exit and this division has historically had low levels of churn per annum. This division has 4 to 5 large customers which account for ~25% of revenue and the loss of one of these would have an adverse impact on earnings. Beyond this, the wholesale customer base is very diversified.

Over the medium term, we forecast 5% organic revenue growth and 8% EBITDA margins through cross-selling and increased market penetration

- Over the medium term, the three major revenue drivers in the M2 Wholesale division are 1) MTU's existing wholesale clients increasing their retail client base; 2) MTU's existing wholesale clients increasing their product range (mobile and data products) to their existing retail client base; and 3) MTU increasing its wholesale client base. In FY11 and FY12, we forecast the above factors will deliver 5% organic revenue growth and we forecast stable EBITDA margins of 8%.

Figure 8. Earnings forecasts for M2 Wholesale

	FY08	FY09	FY10F	FY11F	FY12F
Revenue	70	128	140	147	154
Revenue Growth		*83%*	*9.4%*	*5%*	*5%*
EBITDA	3.5	8.4	11.2	11.8	12.3
EBITDA Margin	*5.0%*	*6.6%*	*8.0%*	*8.0%*	*8.0%*

Source: Lodge Estimates

Risks to earnings forecasts

- **Internal systems integration:** MTU has made 5 acquisitions over the past 3 years and has a range of internal billing and financial reporting systems. In FY10 and FY11, we expect MTU will make progress in consolidating these systems at a total cost of $2-3m. MTU currently uses 6-7 different operating systems but would like to move down to 2 over the next few years.

We view the key risk to earnings as internal systems integration

Although management maintains that there is no sense of urgency to the internal IT transformation, we remain cognisant of the risks in migrating customer profiles and billing systems to a new platform and the potential for service disruption and increased customer churn. We view this as the single biggest risk to our earnings forecasts for MTU.

- **Supplier relationships:** MTU relies on the supply of telco services from Telstra and Optus to support its reseller model. A potential risk to this model is that one of these suppliers experiences service disruptions (which flows through to MTU's customers) or if one of the suppliers uses their bargaining power to squeeze MTU's margins.

We expect that MTU will increase its bargaining power with suppliers due to its increased scale

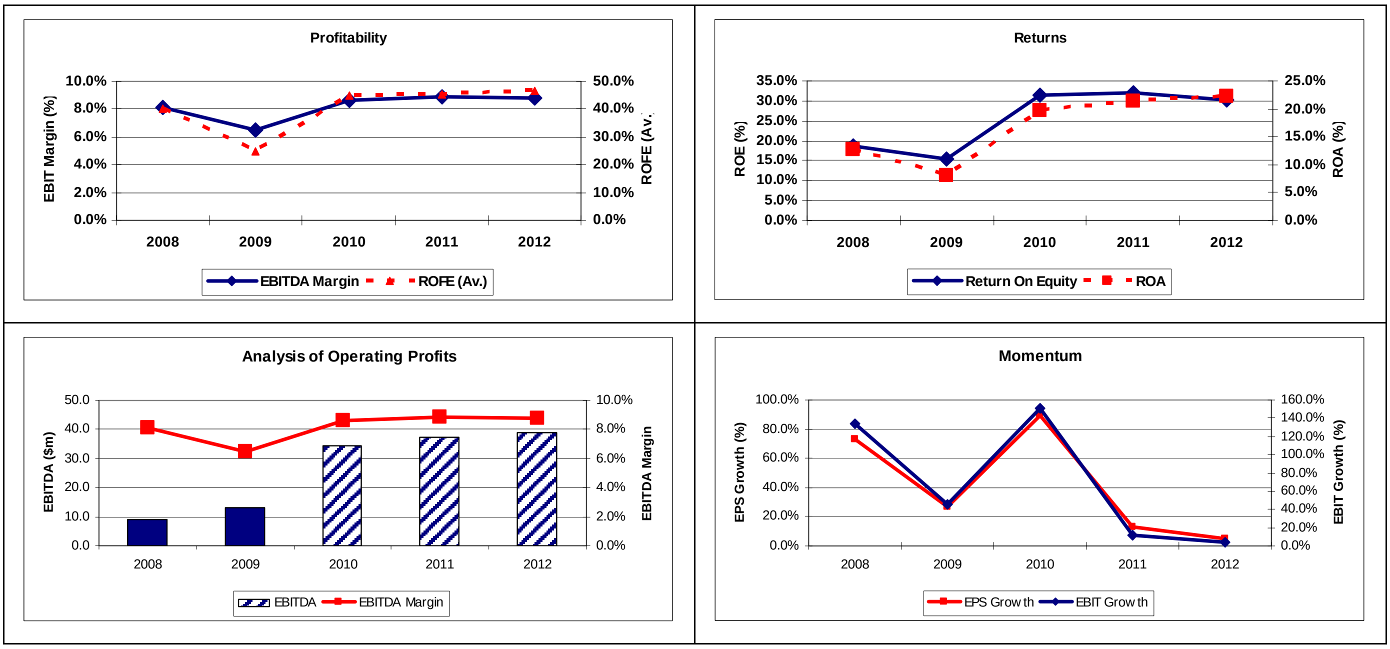
We believe that MTU has mitigated this risk by having competitive tension between the two suppliers. MTU is now a sizeable wholesale customer for both Telstra and Optus and we would expect both telcos would like to keep and grow their volumes with MTU. In fact, we find it believable that MTU's bargaining position will increase with its major suppliers (due to its recent increase in scale) as they move towards the creation of umbrella contracts to cover all services with volume discounts.

- **Competition –** It is possible that Telstra or Optus may compete more aggressively in the SME market in the future, which may lead to price discounting and increased customer churn for MTU. However we believe that the SME market is sufficiently fragmented and the barriers to entry are high enough, in terms of branding, economies of scale and customer service, that MTU's market share will be sustained over the short to medium term.

- **The NBN –** At this stage, it is unclear what impact the NBN will have on MTU's business model or forecast earnings. On the positive side, the NBN may improve the quality of telco services for MTU to resell to the SME market. On the negative side, the NBN may increase the level of competition in the market and MTU may have to renegotiate supply contracts with a new entity. In any case, the NBN is unlikely to impact MTU's earnings over the next 2-3 years.

The impact of the NBN on MTU's medium term earnings are uncertain

Figure 9. Earnings Analysis



Source: Lodge Estimates

Cashflow and Balance Sheet Analysis

MTU generates solid OPCF and has positive working capital

- MTU generates solid operating cashflows and we forecast that new operating cashflow will increase from $8.3m in FY09 to $27.1m in FY10. MTU has positive working capital as their debtor days are at 14-30 days, which is shorter than the terms with suppliers at 30-45 days.
- As at 30 June 2009, MTU had total debt of $16.3m and net debt of $9.6m. In FY10, we expect that MTU will pay down at least $5m in debt and end up with a net debt position of $5.6m as at 30 June 2010. We remain comfortable with MTU's gearing levels at net interest cover of 24x in FY10. We expect that MTU will pay down debt and be net cash positive by FY12.

We remain comfortable with MTU's gearning

- As at June 2009, MTU had $70.3m of intangibles on the balance sheet, of which $68.6m was classified as goodwill. In FY10, we expect ~$15m of this goodwill will be reclassified as customer contracts, which will be amortised over ~3 years. We note that this $5m in amortisation expense can be added back to 'normalised NPAT' in FY10 and beyond.
- In August 2009, MTU paid a further $10.5m for the Commander acquisition and will pay the final deferred consideration in instalments over 3 years.
- As at 30 June 2009, MTU had only $5.1m of PPE on the balance sheet, which reflects its network reseller model which requires minimal infrastructure. We forecast $3m of capex per year of the forecast period, which will be sufficient to invest in internal systems upgrades.

The balance sheet reflects MTU's low capex model

Figure 10. Balance sheet and cashflow analysis

Year to 30 June		2009	2010F	2011F	2012F
Receivables	$m	50.1	50.5	53.1	55.7
Net Working Capital Position	$m	1.0	(12.6)	(0.8)	(0.8)
Net Debt/(Cash)	$m	9.6	5.6	4.0	(7.7)
Operating Cashflow	$m	8.3	27.1	23.4	30.0
Operating Cashflow Per Share	c	9.9	24.7	21.3	27.2

Source: Lodge Estimates

Profitability Analysis

MTU has a solid history of profit growth on a per share basis

- In FY09, MTU delivered 37% growth in EPS_{adj} despite a 38% increase in the number of shares on issue. In FY10, we forecast 97% growth in EPS_{adj} off a stable equity base.
- In FY10, we forecast a step change in MTU's earnings and profitability due to the full year impact of the People Telecom and Commander acquisitions as well as the favourable impact of the ACCC indicative ruling to decrease the Wholesale Line Rental.
- We forecast EBITDA Margins increase from 6.5% in FY09 to 8.7% in FY10, which flows through to an increase in ROE from 15.4% in FY09 to 32.4% in FY10 and an increase in ROFE from 24.7% in FY09 to 46.6% in FY10.

We forecast margin expansion due to operating synergies and improved network costs through volume discounts

- The MTU Board has a dividend policy of a 70% payout ratio on reported EPS.

Figure 11. Profitability analysis

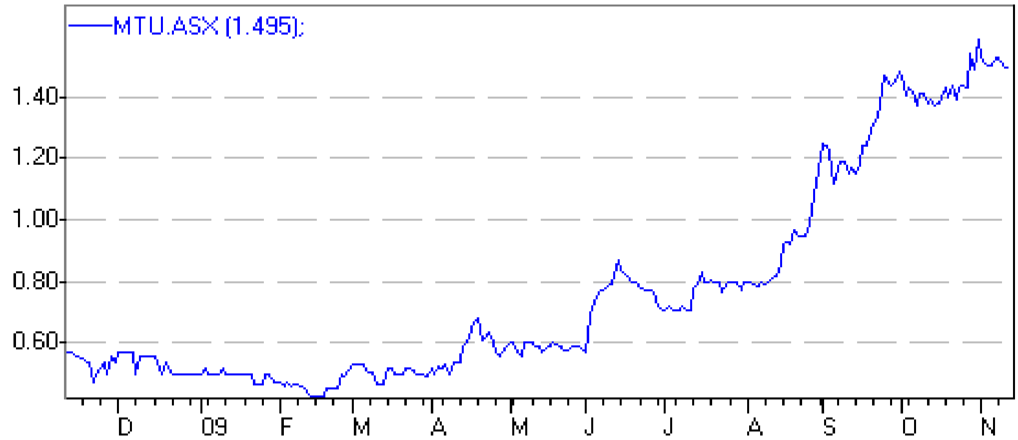
Year to 30 June		2009	2010F	2011F	2012F
Shareholders Equity	$m	48.5	59.2	66.3	73.5
Return on Equity	**%**	15.4%	32.4%	31.7%	30.3%
Dividend Per Share	¢	5.5	12.0	13.5	14.0
Dividend Payout Ratio	%	62%	69%	71%	69%
Funds Employed	$m	58.1	64.7	70.3	65.8
Return on Funds Employed	**%**	24.7%	46.6%	45.6%	47.4%

Source: Lodge Estimates

MTU Company Information

The MTU share price has had a stellar run over the past year

Figure 12. Recent share price history of MTU



Source: IRESS

MTU Board is unchanged since the company first listed in October 2004

DIRECTORS

Mr Craig Farrow	Chairman
Mr Vaughan Bowen	Managing Director and CEO
Mr Max Bowen	Non-Executive Director
Mr Dennis Basheer	Non-Executive Director
Mr John Hynd	Non-Executive Director

Figure 13. Major MTU Shareholders

Substantial Shareholders	Interest in CUS
Hunter Hall	12.3%
Vaughan Bowen	9.9%
SUBSTANTIAL SHAREHOLDERS	**22.3%**

Source: IRESS

M2 Telecommunications (MTU: $1.50)

Mkt Cap: $162.6m

Valuation data

Year ending Jun	2008	2009	2010F	2011F	2012F
Lodge adj profit	**5.2**	**8.1**	**24.2**	**26.0**	**27.3**
Reported profit	5.2	7.5	19.2	21.0	22.3
EPS_{adj} (¢)	**7.0**	**9.6**	**22.1**	**23.6**	**24.8**
EPS growth		**26.6%**	**97.0%**	**9.1%**	**6.0%**
P/E ratio	**21.3 x**	**15.5 x**	**6.8 x**	**6.3 x**	**6.0 x**
DPS (¢)	5.0	5.5	12.0	13.5	14.0
Yield	**3.3%**	**3.7%**	**8.0%**	**9.0%**	**9.4%**
Franking	100.0%	100.0%	100.0%	100.0%	100.0%
Payout ratio	71%	62%	69%	71%	69%
EV / EBIT	21.9 x	15.7 x	5.9 x	5.4 x	4.8 x
EV / EBITDA	18.7 x	13.2 x	4.7 x	4.5 x	4.0 x
CFPS (¢)	9.9	9.9	24.7	21.3	27.2
Price / CF	15.1 x	15.1 x	6.0 x	7.0 x	5.5 x
NTA per share	-$0.06	-$0.20	-$0.15	-$0.09	$0.02
Pr / NTA	-23.1 x	-7.4 x	-9.7 x	-17.1 x	64.3 x

Profit and loss ($M)

Year ending Jun	2008	2009	2010F	2011F	2012F
Sales revenue	109.0	202.5	410.0	430.5	452.0
growth over pcp		*85.9%*	*80.0%*	*3.0%*	*3.0%*
EBITDA	8.8	13.1	35.5	37.3	39.1
Dep'n and amort'n	(1.3)	(2.1)	(6.9)	(6.5)	(6.9)
EBITAg	**7.6**	**11.0**	**28.6**	**30.8**	**32.3**
Goodwill amortisation	0.0	0.0	0.0	0.0	0.0
EBIT	**7.6**	**11.0**	**28.6**	**30.8**	**32.3**
growth over pcp		*44.9%*	*160.4%*	*7.7%*	*4.8%*
Net interest expense	(0.1)	(0.5)	(1.2)	(0.8)	(0.5)
Pre-tax profit	7.5	10.5	27.4	30.0	31.8
Tax	(2.3)	(3.0)	(8.2)	(9.0)	(9.5)
Effective tax rate	*31.2%*	*28.9%*	*30.0%*	*30.0%*	*30.0%*
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	0.0	0.7	5.0	5.0	5.0
Lodge adj profit	**5.2**	**8.1**	**24.2**	**26.0**	**27.3**
Reported profit (pre sig)	5.2	7.5	19.2	21.0	22.3
One-off items (post tax)	0.0	0.0	0.0	0.0	0.0
Reported net profit	5.2	7.5	19.2	21.0	22.3

Balance sheet ($M)

Year ending Jun	2008	2009	2010F	2011F	2012F
Cash	6.9	6.7	5.7	2.3	7.7
Receivables	21.3	50.1	50.5	53.1	55.7
Inventories	0.3	2.6	1.1	1.2	1.2
Other	1.4	2.5	2.5	2.5	2.5
Current assets	**29.9**	**61.9**	**59.8**	**59.0**	**67.1**
Net PPE	1.3	5.1	7.0	8.6	9.9
Investments	0.0	0.0	0.0	0.0	0.0
Goodwill	32.7	70.3	76.1	75.9	70.9
Deferred tax assets	2.8	4.1	4.1	4.1	4.1
Other	0.2	0.1	0.1	0.1	0.1
Non-current assets	**37.0**	**79.5**	**87.2**	**88.7**	**85.0**
Total assets	**66.9**	**141.4**	**147.0**	**147.7**	**152.1**
Debt	10.2	16.3	11.3	6.3	(0.0)
Provisions	0.8	4.1	4.1	4.1	4.1
Other	28.3	72.6	72.6	71.1	74.6
Total liabilities	**39.3**	**92.9**	**87.9**	**81.4**	**78.6**
Equity / reserves	24.3	42.0	42.0	42.0	42.0
Retained profits	3.3	6.5	17.1	24.3	31.5
Total s/h funds	**27.6**	**48.5**	**59.2**	**66.3**	**73.5**
Minorities	0.0	0.0	0.0	0.0	0.0
Total funds emp.	**30.9**	**58.1**	**64.7**	**70.3**	**65.8**

Cashflow ($M)

Year ending Jun	2008	2009	2010F	2011F	2012F
EBIT	7.6	11.0	28.6	30.8	32.3
Net interest paid	(0.3)	(0.7)	(1.2)	(0.8)	(0.5)
Dep'n and amort'n	1.3	2.1	6.9	6.5	6.9
Tax paid	(2.2)	(2.8)	(8.2)	(9.0)	(9.5)
Gross cash from op'ns	**6.3**	**9.5**	**26.1**	**27.5**	**29.1**
(Inc) / dec in wk'g cap	0.0	(1.0)	12.6	0.8	0.8
(Inc) / dec in provisions	2.9	17.5	(11.6)	(4.9)	0.0
Other	(1.9)	(17.7)	0.0	0.0	0.0
Operating cashflow	**7.3**	**8.3**	**27.1**	**23.4**	**30.0**
growth over pcp					
Investing cashflows					
Capital expenditure	(0.6)	(0.9)	(3.0)	(3.1)	(3.2)
Asset sales	0.0	0.0	0.0	0.0	0.0
Investments	(9.6)	(9.7)	(11.6)	(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	0.0	0.5	0.0	0.0	0.0
Dividends paid	(2.8)	(4.3)	(8.5)	(13.8)	(15.1)
Chg in loans	**9.9**	**6.0**	**(5.0)**	**(5.0)**	**(6.3)**
Other non-op flows	0.0	0.0	0.0	0.0	0.0
Net chg in cash	**4.2**	**(0.2)**	**(1.0)**	**(3.4)**	**5.4**

Ratio analysis

Year ending Jun	2008	2009	2010F	2011F	2012F
EBITDA / sales	8.1%	6.5%	8.7%	8.7%	8.7%
EBITAg / sales	7.0%	5.4%	7.0%	7.2%	7.1%
EBIT / sales	**7.0%**	**5.4%**	**7.0%**	**7.2%**	**7.1%**
Return on assets	12.6%	8.1%	20.2%	21.2%	22.3%
Return on equity	**18.7%**	**15.4%**	**32.4%**	**31.7%**	**30.3%**
Return on funds emp.	**40.1%**	**24.7%**	**46.6%**	**45.6%**	**47.4%**
Net debt / (cash) ($M)	3.3	9.6	5.6	4.0	(7.7)
Debt / equity	36.8%	33.5%	19.0%	9.4%	-0.1%
Net debt / equity	**11.9%**	**19.7%**	**9.4%**	**6.0%**	**(10.5%)**
Interest cover	94.7 x	23.9 x	24.2 x	39.2 x	n.a.

Interims ($M)

Half yearly	1HY08	2HY08	1HY09	2HY09
Sales revenue	40.6	68.3	87.1	115.4
EBITDA	3.3	5.5	6.0	7.1
EBIT	**2.7**	**4.8**	**5.0**	**6.0**
Lodge adj profit	**2.0**	**3.2**	**3.2**	**4.9**
Reported profit (pre sig)	2.0	3.2	3.2	4.3
EBITDA / sales	8.1%	8.1%	6.9%	6.1%
EPS (¢)	**2.8**	**4.2**	**4.1**	**5.6**
EPS growth on pcp	n.a.	n.a.	45.7%	32.3%
DPS (¢)	2.0	3.0	2.5	3.0
% of FY EBIT	36%	64%	45%	55%

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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.

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