ORD MINNETT

Company Review

Ord Minnett Research

Tuesday, 1 March, 2011

M2 Telecommunications

1H11 Results

- M2 Telecommunications (MTU) reported a record half year result, with EBITDA of $20.1m, up 31% on the pcp, and underlying NPAT up 37% to $13.1m, slightly below OM estimates of $13.2m.
- Pleasingly, 70% of the increase in revenue was from organic means, with People Telecom the driving force from a divisional perspective. The Retail division overall (which includes People Telecom, Commander and Southern Cross Telco brands) saw NPAT margins increase from 9.8% in 1H10 to 11.6% in 1H11.
- The Wholesale division (branded as M2 Wholesale) saw revenues grow 32% on the pcp, while margins also improved due to positive negotiations with suppliers as their volumes, and hence buying power, increase.
- Post balance date, the Group has made two acquisitions, Clear Telecom for $24.5m (~3x EBITDA), and the business mobile customers of AUSTAR for $2m (~1.5x EBITDA). Both purchases will be funded from internal cash and existing debt facilities.
- Following the completion of these acquisitions, we expect net debt of $22.7m at the full year. Operating cashflow of $24.1m was also strong, but was helped by lower working capital requirements.
- The company remains on the lookout for further acquisition opportunities, and this will be a key catalyst in the 12 months, in our view. The other positive catalyst will be the ACCC decision on wholesale pricing, due shortly.
- We maintain an Accumulate recommendation, increase earnings estimates modestly, upgrade our risk rating to Medium, and our valuation increases to $3.68 per share.

Key Financials

Year-end June (A$)	FY09A	FY10A	FY11E	FY12E
Revenue ($m)	202.7	406.1	453.9	498.9
EBITDA ($m)	13.3	31.4	46.9	62.7
NPAT ($m)	7.5	16.2	25.1	31.4
EPS (cps)	8.9	14.6	20.7	25.8
P/E	41.2	25.1	17.7	14.2
EV/EDITDA	24.7	13.3	10.0	7.4
Dividend (¢)	5.5	10.0	14.5	18.1
Net Yield (%)	1.5	2.7	4.0	4.9
Franking (%)	100	100	100	100
Normalised NPAT ($m)	8.9	18.6	29.3	36.9
Fully Diluted Norm. EPS (¢)	10.2	16.4	24.1	30.3
EPS Growth (%)	na	59.7	47.4	25.9
Normalised P/E	35.8	22.4	15.2	12.1
Relative P/E (x)	2.2	1.5	1.2	1.0
Normalised ROE (%)	18.4	24.2	34.6	39.3

Source: IRESS, Company, Ord Minnett Estimates. Note: all data as at 28 February 2011.

MTU Last A$3.66

Recommendation
Accumulate (Medium Risk)

Integrated Telecom Services

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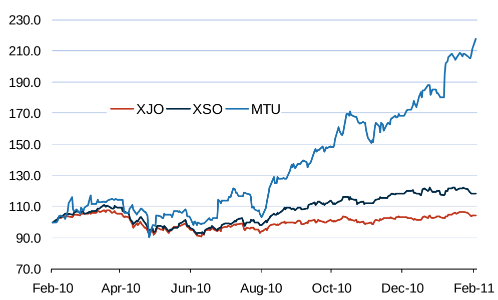
M2 Telecommunications	
ASX Code	MTU
52 week range	A$3.60 - A$ 1.37
Market Cap	A$446 m
Shares Outstanding	121.8m
Av Daily Turnover	A$0.34m
ASX All Ordinaries	4922.6
ASX200 Industrials	3786.0
NTA FY10 (¢ per share)	6.0
Net Debt FY10 ($m)	-1.5

Relative price performance



Source: IRESS

Consensus vs Ord Minnett Earnings

	FY11E	FY12E
NPAT(C)*	-	-
NPAT (OM)	29.3	36.9
EPS (C)*	-	-
EPS (OM)	24.1	30.3

Source: Thomson Financial; Note: One other estimate only.

Financials

M2 Telecommunications Price: $3.66 Recommendation: Accumulate

Profit & Loss Statement (A$m)	FY09A*	FY10A	FY11E	FY12E
Operating Revenue	202.7	406.1	453.9	498.9
Operating Costs	189.4	374.7	407.0	436.2
Share of Associates	0.0	0.0	0.0	0.0
EBITDA	**13.3**	**31.4**	**46.9**	**62.7**
Depreciation & Amortisation	2.1	5.0	7.1	12.1
EBIT	**11.2**	**26.4**	**39.8**	**50.6**
Net Interest Expense	0.7	2.2	4.0	5.8
Pre-Tax Profit	10.5	24.2	35.9	44.8
Tax Expense	3.0	8.0	10.8	13.4
Reported NPAT	**7.5**	**16.2**	**25.1**	**31.4**
Significant Items (After Tax)	0.0	0.0	0.0	0.0
Normalised NPAT	**8.9**	**18.6**	**29.3**	**36.9**
EBITDA Margin (%)	6.6%	7.7%	10.3%	12.6%
Effective tax Rate (%)	28.9%	33.1%	30.0%	30.0%
Diluted EPS (cps)	**8.9**	**14.6**	**20.7**	**25.8**
Diluted Normalised EPS (cps)	**10.2**	**16.4**	**24.1**	**30.3**
DPS (cps)	5.5	10.0	14.5	18.1
Payout Ratio (%)	62.0%	68.6%	70.0%	70.0%
Franking (%)	100%	100%	100%	100%

Key Statistics	FY09A	FY10A	FY11E	FY12E
Revenue				
Retail	112.4	251.5	293.5	325.7
Revenue Growth		*123.6%*	*16.7%*	*11.0%*
Wholesale	90.3	154.7	160.4	173.3
Revenue Growth		*71.3%*	*3.7%*	*8.0%*
Total Revenue	**202.7**	**406.1**	**453.9**	**498.9**

DuPont Analysis	FY09A	FY10A	FY11E	FY12E
EBIT Margin	5.5%	6.5%	8.8%	10.1%
x Asset Turnover	1.43	2.55	2.38	2.39
x Interest Burden	0.94	0.92	0.90	0.88
x Tax Burden	0.85	0.77	0.82	0.82
= Return on Assets	6.3%	11.7%	15.4%	17.7%
x Leverage	2.9	2.1	2.3	2.2
= Return on Equity	18.4%	24.2%	34.6%	39.3%

Cash Flow Statement (A$m)	FY09A*	FY10A	FY11E	FY12E
EBITDA	13.3	31.4	46.9	62.7
Change in Working Capital	5.7	-7.2	-6.4	-5.1
Net Interest (paid)/received	-0.5	-2.0	-4.0	-5.8
Tax Paid	-2.8	-5.9	-10.8	-13.4
Other Operating Items	0.0	-2.1	0.0	0.0
Operating Cash Flow	**8.3**	**13.3**	**25.8**	**38.4**
Asset Sale Proceeds	0.0	0.0	0.0	0.0
Net Acquisitions	-9.1	-3.8	-20.0	-4.5
Capex	-0.9	-1.8	-9.3	-6.9
Other investing items	-0.6	-11.6	0.0	0.0
Investing Cash Flow	**-10.7**	**-17.1**	**-29.3**	**-11.4**
Inc/(Dec) in Equity	0.5	20.4	0.0	0.0
Inc/(Dec) in Borrowings	8.0	20.9	20.0	4.5
Dividends Paid	4.3	8.3	17.6	22.0
Other Financing Items	0.0	0.0	0.0	0.0
Financing Cash Flow	**2.2**	**12.2**	**2.4**	**-17.5**
Net Inc/(Dec) in Cash	**-0.2**	**8.4**	**-1.1**	**9.5**

Largest Shareholders	shares (m)	%	Date
Hunter Hall	13.7	11.2%	Dec 09
Vaughan Bowen	10.2	8.4%	Dec 09
Pengana	8.6	7.1%	Dec 09
Dennis Basheer	5.0	4.2%	Dec 09

Per Share Ratios (A$ cents)	FY09A	FY10A	FY11E	FY12E
Normalised EPS	10.2	16.4	24.1	30.3
Dividend Per Share	5.5	10.0	14.5	18.1
Cash Flow Per Share	9.9	12.0	21.2	31.6
NTA per share	-25.8	6.0	3.9	12.5

Valuation Ratios (x)	FY09A	FY10A	FY11E	FY12E
P/E Multiple	35.8	22.4	15.2	12.1
Price To Book Value	-14.2	60.8	92.8	29.2
Price To Cash Flow	37.1	30.5	17.3	11.6
EBITDA Multiple	24.7	13.3	10.0	7.4
EBIT Multiple	27.6	15.7	11.6	9.0

Balance Sheet (A$m)	FY09A*	FY10A	FY11E	FY12E
Cash	6.7	15.1	14.0	23.5
Inventories	2.6	0.3	0.3	0.3
Receivables	50.1	55.8	65.9	75.2
Other Current Assets	2.5	7.3	7.3	7.3
PP & E	5.1	3.7	16.5	16.8
Intangibles	70.3	70.3	79.7	78.7
Other Non Current Assets	4.2	6.8	6.8	6.8
Total Assets	**141.4**	**159.3**	**190.6**	**208.7**
Short term Debt	3.1	5.1	5.1	5.1
Other Current Liabilities	70.4	61.3	65.1	69.3
Long term Debt	13.1	11.4	31.4	35.9
Other Non Current Liabilities	6.2	4.4	4.4	4.4
Non current liabilities	**19.3**	**15.8**	**35.8**	**40.3**
Total Liabilities	**92.9**	**82.3**	**106.1**	**114.7**
Total Equity	**48.5**	**77.0**	**84.5**	**93.9**
Total liability & Shareholder equity	141.4	159.3	190.6	208.7
Net (Debt)/Cash	-9.6	-1.5	-22.6	-17.6

Leverage	FY09A	FY10A	FY11E	FY12E
Net Debt/Equity	19.7%	2.0%	26.8%	18.7%
Net Debt/Total Assets	6.8%	0.9%	11.9%	8.4%
EBIT Interest Cover (x)	15.6	11.8	10.0	8.7

Valuation	A$m	A$		
WACC (%)			11.1%	
Number of shares (m)			121.8	
Cost of Equity			11.5%	
D/EV			10%	
Risk Free Rate			5.50%	
Operational NPV (5 yr Forecast)	143	1.18		
Terminal Value	328	2.69		
Net (Debt) / Cash	10	0.08		
Franking Credits Value	0	0.00		
Group NPV	461	$\boxed{3.68}$		
Current Share Price		3.66		
Relative to NPV:		0.5%	Disc. to NPV	

Source: Ord Minnett estimates, Company data. *Note: FY09 financials have been revised following completion of acquisitions.

1H11 Results

Table 1: 1H11 Results Summary

	1H10A	FY10A	1H11A	change pcp	FY11E	change pcp
Revenue	187.7	406.1	215.7	14.9%	453.9	11.8%
Opex	-172.3	-374.7	-195.6	13.5%	-407.0	8.6%
EBITDA	15.3	31.4	20.1	30.9%	46.9	49.4%
Depn. & Amort.	-2.7	-5.0	-2.7	-0.1%	-7.1	41.4%
EBIT	12.7	26.4	17.4	37.4%	39.8	50.9%
Interest	-1.1	-2.2	-0.8	-29.2%	-4.0	77.6%
NPBT	11.6	24.2	16.7	43.6%	35.9	48.4%
Tax	-3.4	-8.0	-5.2	52.4%	-10.8	34.3%
Reported NPAT	8.2	16.2	11.5	39.9%	25.1	55.4%
Non-operating items	1.4	2.4	1.6	14.3%	4.2	74.2%
Normalised NPAT	9.6	18.6	13.1	36.1%	29.3	57.8%
EBITDA Margin	8.2%	7.7%	9.3%		10.3%	
EBIT Margin	6.8%	6.5%	8.1%		8.8%	
Effective Tax Rate	29.4%	33.1%	31.2%		30.0%	

Source: Company data, Ord Minnett estimates

Revenue grew mostly from organic means, with acquisitions contributing ~$15m for the half. All of the operating divisions of the M2 Group are now profitable, and given that Commander had been making losses for a year prior to its purchase by MTU, this should not be underestimated.

Opex grew by 13.5% relative to the pcp, and we expect continued focus on costs as the rationalisation of support services, and especially the customer management and billing systems, begins to show benefits in FY12 and beyond. OM expects up to $3m pa in synergy benefits once completed.

EBITDA margins expanded both hoh and against the pcp. OM expects this trend to continue with further industry consolidation likely and an expected favourable ACCC decision likely to flow directly to the bottom line (although some of this benefit will be shared with customers).

Amortisation of customer acquisition costs rose 14% on the pcp to $1.6m. With the acquisitions of Clear Telecom and the AUSTAR mobile assets, we expect an additional $5m in amortisation costs over the next 3 years.

An interim **dividend** of 7 cps was declared, and is in accordance with the long established dividend payout ratio of at least 70%.

After balance date, MTU announced **two acquisitions**, continuing the strategy of consolidation among telecom resellers, especially those serving small and medium businesses. Clear Telecom was bought for $24.5m (~3x EBITDA), and mobile assets were puchased for $2m from AUSTAR Limited (ASX: AUN).

The Clear Telecom acquisition multiple excludes any benefits from the ACCC decision which is still pending, however if we include the same quantum of benefit to this transaction the acquisition multiple falls to between 2.5 – 2.7x EBITDA.

Divisional Summary

Table 2: Segmental Breakdown

Revenue	**FY09A**	**1H10A**	**FY10A**	**1H11A**	**change pcp**	**FY11E**	**change pcp**
Retail	112.4	114.9	251.5	119.6	4.1%	275.7	9.6%
Wholesale	90.3	72.8	154.7	96.1	32.1%	178.2	15.2%
Divisional Revenue	202.7	187.7	406.1	215.7	14.9%	453.9	11.8%

Segment EBT	**FY09A**	**1H10A**	**FY10A**	**1H11A**	**change pcp**	**FY11E**	**change pcp**
Retail	4.6	9.4	17.0	8.9	-5.8%	21.0	23.6%
Wholesale	4.6	1.3	2.4	3.7	188.7%	7.6	221.9%
Segment EBT	9.2	10.7	19.4	12.6	17.8%	28.6	47.8%
Less: Corporate Costs	1.7	2.4	3.2	1.1		3.5	
Reported NPAT	7.5	8.3	16.2	11.5		25.1	
Add: Income Tax	3.1	3.4	8.0	5.2		10.8	
Group NPBT	10.5	11.7	24.2	16.7		35.9	

Source: Company data, Ord Minnett estimates

Within the Retail segment, OM believes People Telecom was the strongest performer, however no disclosures were made at a brand level regarding revenues or profitability. All brands in the M2 stable are now profitable.

In Wholesale, key trends include an increased demand for data and the tendency of small and medium businesses to take up mutliple forms of internet access, including wireless devices and smartphones. For a volume-based model such as MTU's, this will likely drive Wholesale revenues for the foreseeable future.

Balance Sheet and Cashflow

The balance sheet was net cash to the tune of $5m at balance date, however subsequently two acquisitions have been announced, both of which will be funded by cash and existing debt facilities. After accounting for this, OM believes the balance sheet will be net debt to the tune of ~$20m at 30 June 2011.

The other point to note was an inrease in payables that reduced working capital requriements by $10.5m. Consequently, cashflow was much stronger than the pcp, with cashflow conversion of 137.2% for 1H11.

Table 3: Cashflow Conversion

	1H09A	**1H10A**	**1H11A**
EBITDA	6.1	15.3	20.1
Operating Cashflow	4.7	5.6	24.1
Add back tax paid	1.7	2.3	2.1
Add back net interest	0.4	1.2	1.4
OCF pre-int and pre-tax	6.8	9.1	27.7
Cashflow to Earnings	**111.5%**	**59.2%**	**137.7%**
Creditor Days		57.01	61.26
Debtor Days		53.19	48.43

Source: Company data

Outlook

Management maintained the guidance given at the FY10 result for EBITDA of between $41.0 and $42.5m, and for underlying NPAT of between $25.2m and $26.7m.

These forecasts do not include the effects of the ACCC decision still pending, and once known will require upgrades from the company.

OM's updated earnings forecasts (see table 4 below) imply a benefit in FY11 of $4.4m from recent acquisitions as well as the ACCC decision. We feel this is conservative and a best case scenario vis-à-vis the ACCC will require further EBITDA upgrades (on OM estimates) for FY11 of up to 5%.

Changes to Earnings

Following the result we adjust our estimates slightly to account for the stronger run rate and the effect of the AUSTAR mobile acquistion, which had not previously been reflected in estimates.

Table 4: Earnings Estimate Changes

	FY11E Old	FY11E New	% variance	FY12E Old	FY12E New	% variance
Revenue ($m)	449.6	453.9	1.0%	498.9	498.9	0.0%
EBITDA ($m)	45.6	46.9	2.8%	61.6	62.7	1.9%
EBIT ($m)	38.5	39.8	3.4%	49.5	50.6	2.4%
Reported NPAT ($m)	24.2	25.1	3.8%	30.5	31.4	2.7%
EBITDA Margin	10.1%	10.3%		12.3%	12.6%	
Fully Diluted EPS (¢)	23.3	24.1	3.2%	29.7	30.3	2.3%

Source: Ord Minnett estimates

Recommendation and Valuation

We **maintain an Accumulate** recommendation and note that while our **revised valuation of $3.68** is very close to the current price, we await the results of the ACCC review before making further significant changes to earnings estimates or valuations.

We also upgrade our risk rating to **Medium**.

Risk Factors

The key risk is renewed competition from Telstra and others. We believe the chances of Telstra becoming more aggressive in this space are low given their stated intentions to focus on retail broadband and mobile.

Fixed to Mobile substitution creates a risk that the key wedge for MTU, fixed line communication, becomes less relevant for small business. Mobile telephony on its own is lower margin than fixed line.

Integration risk becomes a factor when large acquisitions are made, however MTU has experience with acquisitions of similar size and has proven successful.

Regulatory uncertainty also poses risks around pricing agreements with suppliers, leading to an inability to have sufficient visibility on costs. MTU have long relationships with their suppliers and are one of the largest resellers in Australia which helps mitigate this risk to some degree.

General economic weakness would cause businesses to clamp down on costs, which would invariably include telecommunication costs, and likely pressure margins.

BUSINESS DESCRIPTION

Established in 1999, M2 Telecom is a network independent provider of retail fixed-line, mobile and data telecommunications services, specifically tailored towards Small to Medium Businesses (SMBs) in Australia and New Zealand.

The services are primarily sold via the Commander and People Telecom brands, utilising an on-the-ground sales force to deliver a high touch service to customers.

M2 Telecom also acts as a wholesale supplier of telecommunications services to small internet service providers and other smaller resellers.

Please contact your Ord Minnett Adviser for further information on our document.

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Guide to Ord Minnett Recommendations

BUY	The stock's total return (nominal dividend yield plus capital appreciation) is expected to exceed 15% over 12 months.
ACCUMULATE	The stock's total return is expected to be between 5% and 15%. Investors may add to existing holdings, or initiate holdings on share price weakness.
HOLD	The stock is fairly priced, and its total return is expected to be between 0% and 5%.
LIGHTEN	The stock's total return is expected to be less than 0% and possibly down 15%. Investors should consider selling into share price strength.
SELL	The stock's total return is expected to lose 15% or more.
RISK ASSESSMENT	Classified as High, Medium or Low, denotes the relative assessment of an individual stock's risk based on an appraisal of its disclosed financial information, volatility, nature of its operations and other relevant quantitative and qualitative criteria.