

29 August 2011

# M2 Telecommunications

## Hold (from Buy)

**Important:** The above recommendation has been made on a 12 month view and may not suit your investment needs or timeframe. The basis it is prepared on is summarised on the last page of this report. **PLEASE CONTACT YOUR ADVISER TO DISCUSS THIS GENERAL RECOMMENDATION BEFORE ACTING ON IT.**

## Time for reflection

**MTU delivered a result that was commendable. Underlying NPAT grew 68% to A\$31.3m and the dividend grew 60% to 16c (9c 2H). However the market wasn't impressed with lower than expected guidance and long time CEO stopping for a breather after delivered a series of great results. We move to a Hold.**

### Key Forecasts

Target price  
A\$2.83

Price  
A\$2.73

Market Cap  
A\$341.8m

MTU110829

	2009A	2010A	2011A	2012F	2013F
EBITDA (A\$m)	13.3	31.4	47.2	59.6	67.0
Reported Net Profit (A\$m)	7.5	16.2	27.6	33.1	37.1
Underlying Net Profit (A\$m) <sup>1</sup>	8.2	18.5	31.3	37.2	41.2
Cash EPS (¢) <sup>1</sup>	9.7	16.7	25.1	29.7	32.5
Cash EPS Growth (%)	43.9	72.2	50.3	18.3	9.3
Dividend Per Share (¢)	5.5	10.0	16.0	18.0	20.0
Dividend Yield (%)	2.0	3.7	5.9	6.6	7.3
Cash PE (x)	28.1	16.3	10.9	9.2	8.4
EV/EBITDA (x)	5.2	9.7	7.6	6.0	5.1
Price/Net Oper. CF (x)	7.2	24.8	9.2	10.8	7.2
ROE (%)	16.9	24.1	33.3	35.1	34.5

Source: Company data, RBS Morgans forecasts

### Good result but the outlook disappointed

MTU achieved an impressive result with ~70% NPAT growth which was inline with expectations and our forecast. It has been another big year for MTU and this was a great result in our opinion. However the market reacted negatively to guidance of 15% EPS growth as consensus expectations were for nearly 30% EPS growth. While nobody likes a downgrade we believe the rationale is sound as the additional costs relate to MTU undertaking a significant internal investment. As we flagged in our last note, MTU will now turn its attention towards improving internal systems and the sales process. While we expected this to happen we underestimated how costly this would be and have consequently reduced our EPS forecasts by 15% in FY12. The negative share price reaction may also have related to the fact the long time CEO and substantial shareholder Vaughan Bowen has opted to step aside from his role as CEO. Mr Bowen will remain in a full time position, moving to an Executive Director role and Chief Operating Officer Geoff Horth will assume the CEO in late October. We've previously meet Mr Horth and are confident in his abilities in the role.

### Time to stop and smell the roses

MTU delivered a good result with impressive NPAT, EPS and dividend growth. The gross margin and EBITDA margin expanded as well. Operating cashflow wasn't as strong as we had expected but its appears to be timing differences. The 33% ROE remains very attractive and MTU will concentrate on internal optimisation in FY12 before returning to strong growth in FY13. We think this is a sensible strategy as MTU has been very active on the acquisition trail in recent years, and while it has delivered good results it's important, in our opinion, to fully integrate the acquisitions and take stock of the situation before taking the next majors steps. We believe a strong internal focus in FY12 will lead to a better outcome in FY13.

### Investment view: We move back to a Hold recommendation on valuation grounds

Following a reduction in our FY12 forecasts, our valuation and price target has fallen from A\$3.95 to A\$2.83 and we move to a Hold recommendation. Key risks relate to revenue and margin pressure from suppliers and likelihood of increased competition under the NBN. Upside risk relates to acquisitions and better than expected cost savings.

### Analysts

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## Results snapshot

### General comments

\* Great result, as expected but the market reacted negatively to guidance of 15% EPS growth as expectations were for nearly 30%

\* On face value revenue declined 3.3% (2H11 vs 2H10), however this reflects the removal of commission revenue so is not directly comparable. On a 12 month basis MTU's passed through A\$55m in commission revenue to e-Direct. It has since acquired e-Direct and no longer pays the revenue. In reality revenue grew around 7% on an organic basis.

\* Gross profit margins expanded to 27.4% in the 2H11 and 24.5% in FY11 (from 21.7% in the 1H11 and 21.9% in FY10). This relates to better buying power and a partial contribution from the ACCC lowering line rental and calling costs

\* Gross margins should trend upwards in FY12 thanks to better buying power and the ACCC ruling. The Board is forecasting an EBITDA margin of ~15%.

\* Operating costs trended down slightly yoy and will continue to decline as cost saving / acquisition synergies flow through.

\* The board declared a 9c 2H dividend which was ahead of our 8c forecast and takes the full year to 16cps.

\* FY12 guidance was lower than expected and translates to 15% EPS growth.

\* Capex will be higher in FY12 than we'd forecast given MTU's new business support system called "Ninja" which will consolidate numerous legacy billing, provisions, and customer relationship systems. This will cost in FY12 but should see MTU enter FY13 with a much lower cost base.

An internal focus has seen us reduced our EPS forecasts by 15% (from 30% to 15% EPS growth in FY12). This reflects our view that management will spend around A\$9m in FY12 on internal initiatives. These include the new business support systems that will deliver business wide billing, provisioning, customer support, web-based customer care and dealer support. Following acquisition activity MTU runs numerous legacy systems in parallel. The new system will help MTU consolidate these multiple systems down into one and will ultimately lower its operating costs as a consequence.

This will ultimately allow for a more efficient business and positions MTU well. We think this is a sensible strategy as MTU has been very active on the acquisition trail in recent years. While MTU's acquisition track record has delivered good results it's important, in our opinion, to fully integrate the acquisitions and take stock of the situation before taking the next majors steps. We generally get nervous when companies continue to make acquisitions without taking the time to correctly absorb prior acquisitions. In our experience it generally take 12-24 months for an acquirer to completely absorb and integrate an acquisition. We believe a strong internal focus in FY12 will lead to a better outcome in FY13 and believe this is in the best interests of shareholders.

**Table 1 : Results snapshot**

	1H09	2H09	1H10	2H10	1H11A	2H11A	FY09A	FY10A	FY11A	A vs F	RBSM FY11F	RBSM FY12F
<b>Profit and loss</b>												
Revenue	87.3	115.5	187.7	218.4	215.7	211.1	202.7	406.1	426.8	-8.3%	465.2	387.0
Gross profit	15.7	20.5	45.7	43.5	46.7	57.8	36.3	89.1	104.5	-3.1%	107.8	108.8
Gross profit margin	18.0%	17.8%	24.3%	19.9%	21.7%	27.4%	17.9%	21.9%	24.5%	1.1%	23.2%	28.1%
Operating costs	9.6	13.3	30.3	27.4	26.6	29.6	22.9	57.7	56.2	-6.3%	60.0	49.3
Operating EBITDA	6.1	7.2	15.4	16.0	20.1	28.2	13.3	31.4	48.3	0.9%	47.9	59.6
EBITDA margin	7.0%	6.2%	8.2%	7.3%	9.3%	13.4%	6.6%	7.7%	11.3%	1.1%	10.3%	15.4%
Operating EBIT	5.2	6.1	12.7	13.5	17.4	24.9	11.2	26.2	42.3	1.1%	41.8	49.3
EBIT margin	5.9%	5.3%	6.8%	6.2%	8.1%	11.8%	5.5%	6.5%	9.9%	1.1%	9.0%	12.7%
PBT	4.7	5.8	11.6	12.6	16.7	23.8	10.5	24.2	40.4	1.1%	40.0	47.4
Tax	1.5	1.5	3.4	4.6	5.2	7.6	3.0	8.0	12.8	-3.1%	13.2	14.4
Reported NPAT	3.2	4.3	8.2	8.0	11.5	16.1	7.5	16.2	27.6	3.1%	26.8	33.1
Underlying NPAT	3.2	5.0	9.6	9.0	13.1	18.2	8.2	18.5	31.3	2.4%	30.6	37.2
EPS	3.9	4.5	7.4	6.8	9.2	13.4	8.4	14.2	22.6	3.8%	21.8	26.4
Underlying EPS	4.0	5.7	8.7	8.0	10.7	14.6	9.7	16.7	25.3	1.8%	24.8	29.7
DPS	2.5	3.0	5.0	5.0	7.0	9.0	5.5	10.0	16.0	6.7%	15.0	18.0
Payout ratio	63.5%	66.7%	67.7%	73.6%	76.0%	67.2%	65.2%	70.5%	70.8%		68.9%	68.1%
<b>Year on Year growth</b>												
Revenue			115.0%	89.2%	14.9%	-3.3%			5.1%			-9.3%
Gross profit			190.3%	111.6%	2.3%	33.0%			17.3%			4.1%
EBITDA			150.0%	122.8%	30.8%	75.8%			53.6%			-17.9%
Reported NPAT			156.4%	86.1%	39.9%	102.6%			70.4%			19.8%
Underlying NPAT			199.1%	78.7%	37.2%	103.4%			69.2%			18.8%
EPS			87.6%	50.9%	24.6%	97.2%			59.4%			16.9%
Underlying EPS			117.5%	40.4%	23.0%	82.5%			51.5%			17.4%
DPS			100.0%	66.7%	40.0%	80.0%			60.0%			12.5%
<b>Half on Half growth</b>												
Revenue	32.3%	62.6%	16.4%	-1.2%	-2.1%							
Gross profit	30.6%	122.3%	-4.8%	7.5%	23.8%							
EBITDA	17.3%	113.1%	4.6%	25.1%	40.5%							
Reported NPAT	34.1%	91.2%	-2.7%	43.7%	41.0%							
Underlying NPAT	56.8%	90.7%	-6.3%	46.4%	38.9%							
EPS	14.2%	64.2%	-8.1%	35.6%	45.4%							
Underlying EPS	42.5%	52.6%	-8.0%	33.8%	36.4%							
DPS	20.0%	66.7%	0.0%	40.0%	28.6%							

Source: RBS Morgans estimates

**Table 2 : Valuation**

Company	FY12F PE (x)
TPG	11.2
iiNet	7.5
Amcom	12.5
Macquarie Telecom	9.5
<b>Average</b>	<b>10.2</b>
M2 Telecom	
MTU FY12F earnings per share	29.7
Multiple applied	10.2
MTU PE valuation (A\$)	3.03
MTU DCF valuation (A\$)	2.63
<b>Weighted valuation (A\$)</b>	<b>2.83</b>

Source: RBS Morgans estimates

We've cut out EPS forecasts by ~15% and move to a Hold on valuation grounds. While we highlight MTU's best in sector ROE (33% for FY11) we believe that it is trading at fair value on a relative basis (FY12 F PE of 9.2x vs person on 10.2x). Our DCF based valuation has also fallen as we've reduce our earnings in the near term as increased our capex assumptions around the system refresh and ongoing capital requires for MTU. MTU has traditionally been a capex light business but in light of its scale and the changing industry dynamics, we expect they will look to invest further in systems and processes in coming years.

**Table 3 : Changes to our forecast and valuation**

	FY11			FY12F			FY13F		
	F	Actual	% Chg	Old	New	% Chg	Old	New	% Chg
Divisional sales	405.2	425.8	5.1%	531.9	387.0	-27.2%	546.6	404.0	-26.1%
EBITDA	47.9	47.2	-1.4%	68.7	59.6	-13.3%	69.4	67.0	-3.5%
Reported NPAT	26.8	27.6	3.1%	38.6	33.1	-14.3%	39.8	37.1	-6.7%
Underlying NPAT	30.6	31.3	2.2%	43.9	37.2	-15.3%	45.0	41.2	-8.4%
Reported EPS	21.8	22.2	2.0%	31.2	26.4	-15.3%	32.0	29.2	-8.6%
Underlying EPS	24.8	25.1	1.2%	35.5	29.7	-16.3%	35.6	32.5	-8.8%
DPS (c)	15.0	16.0	6.7%	22.0	18.0	-18.2%	22.0	20.0	-9.1%
DCF valuation (A\$)	4.03	2.63	-34.7%						
PE compco valuation (A\$)	3.87	3.03	-21.7%						
<b>Weighted valuation (A\$)</b>	<b>3.95</b>	<b>2.83</b>	<b>-28.4%</b>						

Source: RBS Morgans estimates

Chart 1 : MTU – financial summary

	AIFRS 2010A	AIFRS 2011A	AIFRS 2012F	AIFRS 2013F	AIFRS 2014F	Closing price (A\$)	2.73	Price target (A\$)	2.83	
<b>Income statement</b>						<b>DCF valuation inputs</b>				
Divisional sales	406.1	425.8	387.0	404.0	412.2	Rf	5.25%	10-year rate	5.25%	
Total revenue	406.1	425.8	387.0	404.0	412.2	Rm-Rf	6.00%	Margin	2.0%	
Operating costs	374.7	378.6	327.5	337.1	339.7	Beta	1.50	Kd	8.00%	
EBITDA	31.4	47.2	59.6	67.0	72.5	CAPM (Rf+Beta(Rm-Rf))	14.3%	Ke	15.6%	
Associate income	0.0	0.0	0.0	0.0	0.0	E/EV*Ke+D/EV*Kd(1-t)		NPV cash flow (A\$m)	345.2	
Depreciation	1.8	1.4	4.2	5.8	4.5	Equity (E/EV)	80.0%	Minority interest (A\$m)	0.0	
EBITA	29.7	45.8	55.4	61.2	67.9	Debt (D/EV)	20.0%	Net debt (A\$m)	15.8	
Amortisation/impairment	3.5	4.6	6.1	6.1	0.0	Interest rate	8.00%	Investments (A\$m)	0.0	
EBIT	26.2	41.2	49.3	55.2	67.9	Tax rate (t)	30.0%	Equity market value (A\$m)	329.4	
Net interest expense	2.0	0.8	1.9	2.0	1.3	WACC	13.5%	Diluted no. of shares (m)	125.2	
Pre-tax profit	24.2	40.4	47.4	53.2	66.7					
Income tax expense	8.0	12.8	14.4	16.1	20.0	<b>PE compco</b>	<b>\$3.03</b>	<b>DCF valuation</b>	<b>\$2.63</b>	
After-tax profit	16.2	27.6	33.1	37.1	46.7	FY10 PE compco multiple applied	10.2x	<b>Weighted valuation</b>	<b>\$2.83</b>	
Reported NPAT	16.2	27.6	33.1	37.1	46.7					
Underlying NPAT	18.6	31.3	37.2	41.2	46.3	<b>Multiples</b>	<b>2011A</b>	<b>2012F</b>	<b>2013F</b>	<b>2014F</b>
						Enterprise value (A\$m)	359.0	357.6	340.2	322.5
						EV/Sales (x)	0.8	0.9	0.8	0.8
						EV/EBITDA (x)	7.6	6.0	5.1	4.4
						EV/EBIT (x)	8.7	7.3	6.2	4.7
						Cash PE (pre-amortisation) (x)	10.9	9.2	8.4	7.6
						PEG (pre-amortisation) (x)	0.2	0.5	0.9	0.7
						Dividend yield	5.9%	6.6%	7.3%	9.2%
						Operating cashflow yield	10.9%	9.3%	13.8%	14.3%
						Free cashflow yield	-2.6%	4.0%	10.7%	11.9%
						<b>At target price</b>	<b>2011A</b>	<b>2012F</b>	<b>2013F</b>	<b>2014F</b>
						EV/EBITDA (x)	7.5	5.9	5.3	4.9
						PE (pre-goodwill) (x)	12.7	10.7	9.7	7.8
						<b>Comparable company data (x)</b>	<b>2011A</b>	<b>2012F</b>	<b>2013F</b>	<b>2014F</b>
						Data#3				
						EV/EBITDA	6.9	5.4	4.8	4.5
						EV/EBIT	7.1	5.6	5.1	4.7
						PE	13.1	11.9	11.2	10.8
						Macquarie Telecom Group				
						EV/EBITDA	3.3	3.4	2.5	2.4
						EV/EBIT	5.7	5.9	4.5	4.7
						PE	10.0	9.5	7.9	7.6
						<b>Per share data</b>	<b>2011A</b>	<b>2012F</b>	<b>2013F</b>	<b>2014F</b>
						No. shares	123.0	125.2	126.9	128.7
						Reported EPS (cps)	22.2	26.4	29.2	36.3
						Underlying EPS (c)	25.1	29.7	32.5	36.0
						Operating cash flow per share	29.8	25.3	37.7	39.1
						Free cashflow per share	-7.2	10.8	29.2	32.5
						Dividend per share (c)	16.0	18.0	20.0	25.0
						Dividend payout ratio (%)	72.0%	68.1%	68.4%	68.9%
						Dividend yield (%)	5.9%	6.6%	7.3%	9.2%
						<b>Growth ratios</b>	<b>2011A</b>	<b>2012F</b>	<b>2013F</b>	<b>2014F</b>
						Sales growth	4.8%	-9.1%	4.4%	2.0%
						Operating cost growth	1.0%	-13.5%	2.9%	0.8%
						EBITDA growth	54.3%	21.0%	10.5%	10.9%
						EBITA growth	54.3%	21.0%	10.5%	10.9%
						EBIT growth	57.3%	19.7%	11.8%	23.2%
						Reported NPAT growth	70.6%	19.7%	12.2%	25.7%
						Normalised NPAT growth	69.0%	18.9%	10.8%	12.4%
						Reported EPS growth	56.8%	18.8%	10.7%	24.0%
						Cash EPS growth	50.3%	18.3%	9.3%	10.9%
						<b>Operating performance</b>	<b>2011A</b>	<b>2012F</b>	<b>2013F</b>	<b>2014F</b>
						Asset turnover (%)	59.0	46.5	45.5	43.1
						EBITDA margin (%)	11.1	15.4	16.6	17.6
						EBIT margin (%)	9.7	12.7	13.7	16.5
						Net profit margin (%)	6.5	8.5	9.2	11.3
						Return on net assets (%)	0.0	0.0	0.0	0.0
						Net debt (A\$m)	17.2	15.8	-1.6	-19.3
						Net debt/equity (%)	18.3	14.9	-1.4	-14.0
						Net interest/EBIT cover (x)	52.3	26.0	28.3	53.2
						ROE (%)	33.3	35.1	34.5	33.7
						ROIC(%)	30.8	33.9	34.7	38.3
<b>Balance sheet</b>	<b>2010A</b>	<b>2011A</b>	<b>2012F</b>	<b>2013F</b>	<b>2014F</b>					
Cash & deposits	15.1	12.5	13.9	31.4	49.0					
Trade debtors	55.8	51.1	63.6	66.4	67.8					
Inventory	0.3	0.4	0.4	0.4	0.4					
Investments	0.0	0.0	0.0	0.0	0.0					
Goodwill	0.0	0.0	0.0	0.0	0.0					
Other intangible assets	70.3	116.6	114.0	110.3	110.3					
Fixed assets	3.7	3.4	5.2	3.6	3.3					
Other assets	14.1	17.3	17.3	17.3	17.3					
<b>Total assets</b>	<b>159.3</b>	<b>201.4</b>	<b>214.4</b>	<b>229.4</b>	<b>248.2</b>					
Short-term borrowings	5.1	12.5	3.0	3.0	3.0					
Trade payables	54.2	57.5	58.3	60.0	60.5					
Long-term borrowings	11.4	17.3	26.8	26.8	26.8					
Provisions	6.7	9.9	9.9	9.9	9.9					
Other liabilities	4.8	10.5	10.5	10.5	10.5					
<b>Total liabilities</b>	<b>82.3</b>	<b>107.6</b>	<b>108.5</b>	<b>110.2</b>	<b>110.6</b>					
Share capital	62.9	66.8	78.9	92.2	110.5					
Other reserves	0.3	0.3	0.3	0.3	0.3					
Retained earnings	13.7	26.7	26.7	26.7	26.7					
Other equity	0.0	0.0	0.0	0.0	0.0					
<b>Total equity</b>	<b>77.0</b>	<b>93.8</b>	<b>106.0</b>	<b>119.3</b>	<b>137.6</b>					
Minority interest	0.0	0.0	0.0	0.0	0.0					
Total shareholders' equity	77.0	93.8	106.0	119.3	137.6					
<b>Total liabilities &amp; SE</b>	<b>159.3</b>	<b>201.4</b>	<b>214.4</b>	<b>229.4</b>	<b>248.2</b>					
<b>Internal liquidity</b>	<b>2010A</b>	<b>2011A</b>	<b>2012F</b>	<b>2013F</b>	<b>2014F</b>					
Current ratio (x)	1.0	0.7	0.8	1.0	1.2					
Receivables turnover (x)	7.7	8.0	6.7	6.2	6.1					
Payables turnover (x)	6.8	6.8	5.7	5.7	5.6					

Source: Company data; RBS Morgans estimates



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