Lodge Partners Research
ABN: 25 053 432 769
AFS: 246271

BUY - $2.73

M2 Communications (MTU)

Accounting for acquisition and slower retail revenue growth lead to downgrades

Stephen Cleugh
+61 3 9200 7032
s.cleugh@lodgepartners.com.au

MTU reported an underlying net profit of $31.4m which represented a 55% increase over the pcp. This was in line with market guidance. However it was achieved on adjusted revenue of $445m ($426m reported) which was below management's guidance. Slower revenue growth was generated by the group's retail businesses. Despite the lower than expected sales numbers EBITDA margins showed significant improvement (+45%). Part of the margin improvement related to the accounting for the Edirect acquisition in the final quarter of 2011. Net debt ended the year at $17m which was a little higher than expected due to an issue with working capital, these will be rectified during Q1 2012 and debt levels should reduce. Directors declared a final dividend of 9cps, taking the annual payment to 16cps, in line with its 70% payout ratio guidance.

Due to the slower growth in sales and much lower guidance for 2012, than we expected, we have lowered our expectations for the group's recent acquisitions and divisions. We now forecast Clear to have an annual sales run rate of 55m vs $70m, Austar annual sales run rate of $7m vs $10m, and Edirect annual sales run rate of $13m. We are also forecasting the wholesale division to contribute around $90m in sales during 2012, down from $169m in 2011.

We have increased our EBITDA margin to 14.7%, in line with management guidance of 15%. This significant increase reflects the absence of Edirect wholesale revenue of around $55m in the nine months to March 2011, which did not generate any profit margin. The majority of the margin increase therefore comes through the wholesale operations. The additional costs being spent on increased marketing and improved lead generation of between $5m and $9m are expected to be ongoing and are expected to assist MTU generate an organic growth rate of around 5% in its Retail business during 2012 and beyond.

The handing over of the CEO's position by Vaughan Bowen to his COO Geoff Horth, whilst a surprise to the market, will allow Vaughan to focus more on supplier and carrier relationships as well as acquisitions, in his new capacity as an Executive Director.

Our previous forecast net profit, EPS and DPS numbers have been pushed out by around twelve months reflecting the slower than expected growth in sales being achieved and the higher costs being incurred to generate improved organic growth. This has resulted in a 15% downgrade to 2012 NPAT and EPS.

Recommendation

Nevertheless, based on our revised forecasts MTU is trading on a prospective fully franked dividend yield of 7% in 2012. Our revised twelve month price target of $4.13 also provides significant upside from capital growth. Hence our twelve month total return of 58% leads us to **maintain our BUY** recommendation on the stock.

Company Data

ASX Code	MTU
Price	$2.73
12 month price target	$4.13
12 month dividend yield	7.0%
Implied return	58.3%
Shares on issue	123.6m
Market capitalisation	$337.5m
12 Month price range	$4.08/$1.74
Monthly turnover	5.29m

Forecast Changes

	2012f	2013f	2014f
NPAT	-15.4%	-11.2%	n/a
EPS	-15.2%	-11.4%	n/a
DPS	-20.8%	-17.2%	n/a

Earnings Summary

Yr to 30 June	2011	2012F	2013F	2014F
Lodge adj profit	31.4	38.0	44.4	48.9
Rep. Profit(pre-abn)	27.6	33.5	42.2	48.9
EPS pre goodwill (¢)	25.6	30.8	35.9	39.6
EPS growth	55.4%	20.3%	26.1%	15.9%
P/E ratio	10.7 x	8.9 x	7.6 x	6.9 x
DPS (¢)	16.0	19.0	24.0	28.0
Yield	5.9%	7.0%	8.8%	10.3%
Franking	100%	100%	100%	100%
Payout ratio	71%	70%	70%	71%
EV / EBIT	8.6 x	7.1 x	5.4 x	4.4 x
EV / EBITDA	7.5 x	5.8 x	4.8 x	4.3 x
CFPS (¢)	32.4	36.5	40.1	41.6
Price / CF	8.4 x	7.5 x	6.8 x	6.6 x
NTA per share	-$0.18	-$0.05	$0.12	$0.26
Pr / NTA	-14.8 x	-60.4 x	21.9 x	10.4 x

Share Price Chart

Source: Iress Market Technology

Result summary

Full Year to 30 June	**FY10**	**FY11**	**% chg on pcp**	
Profit and loss statement				
Sales revenue	406.1	426.8	5.1%	*On an adjusted basis $5m below bottom end of guidance*
EBITDA	31.1	47.2	52.0%	*EBITDA in line; includes $1.6m bad debt provision re: Edirect*
Depreciation	(1.5)	(1.4)	-5.5%	*depreciation low- asset light business model*
Amortisation	(3.5)	(4.6)		*multiple acquisitions over recent years*
EBIT	**26.1**	**41.2**	**58.0%**	
Net interest expense	(2.0)	(0.8)	**60.4%**	*in line with expectations*
Pre-tax profit	24.1	40.4	67.8%	
Tax expense	(8.0)	(12.8)	59.5%	
Reported profit	**16.1**	**27.6**	**72.0%**	*about $1m lower than expected due to higher tax rate*
Significant items	0.0	0.0		
NPAT (pre sig)	16.1	27.6	72.0%	
Adjustments	2.4	3.7		*amortisation of customer contracts was expected to be $3.9m*
Lodge adj profit	**18.4**	**31.4**	**70.1%**	*Adds back non-cash amortisation of customer contracts*
Tax rate (%)	33.3%	31.6%	-1.7%	*due to adjustment on prior yr income tax*
EBITDA margin (%)	**7.6%**	**11.1%**	**44.6%**	*removal of no margin commission in Edirect, and staff cost savings*
EBIT margin (%)	**6.4%**	**9.7%**	**50.4%**	
EPS (adj)	**16.6**	**25.6**	**53.7%**	*EPS growth < NPAT growth around 10% extra shares on issue*
DPS	10.0	16.0	60.0%	
Payout ratio	69.0%	71.0%	2.0%	*consistent with 70% target payout ratio*
Cash flow statement				
EBITDA	31.1	47.2	52.0%	*in the absence of acquisitions, strong free cash generation in FY11*
Net interest paid	(2.2)	(1.9)		
Tax paid	(5.9)	(4.1)		
Gross cash from op'tions	**22.9**	**41.3**	**79.9%**	
(Inc) / dec in working cap.	(6.2)	7.8	-226.0%	*controlled working capital, considering growth and a acquisitions*
Other non-cash items	(3.4)	(9.4)	-175.1%	
Operating cash flow	**13.3**	**39.7**	**198.7%**	
Balance sheet				
Working capital ($M)	1.9	(6.0)	420.6%	*tight working capital management*
Net debt (cash) ($M)	1.5	17.2	1038.9%	*debt higher than expected, has corrected itself in Q1 2012*
Net debt / equity	2.0%	18.3%	835.2%	*low gearing levels balance sheet capacity for acquisitions*
Net interest cover	13.1	52.3	298.8%	*high interest coverage*
Return on equity (%)	20.9%	29.5%	8.6%	*ROE well above WACC of 12.2%*
ROA (%)	18.1%	21.8%	3.8%	*asset light business model*

M2 Telecommunications (MTU: $2.73)

Mkt Cap: $337.5m

Valuation data

Year ending Jun	2010	2011	2012F	2013F	2014F
Lodge adj profit	**18.4**	**31.4**	**38.0**	**44.4**	**48.9**
Reported profit	16.1	27.6	33.5	42.2	48.9
EPS $_{adj}$ (¢)	**16.6**	**25.6**	**30.8**	**35.9**	**39.6**
EPS growth	**65.5%**	**55.4%**	**20.3%**	**26.1%**	**15.9%**
P/E ratio	**16.4 x**	**10.7 x**	**8.9 x**	**7.6 x**	**6.9 x**
DPS (¢)	10.0	16.0	19.0	24.0	28.0
Yield	**3.7%**	**5.9%**	**7.0%**	**8.8%**	**10.3%**
Franking	100.0%	100.0%	100.0%	100.0%	100.0%
Payout ratio	69%	71%	70%	70%	71%
EV / EBIT	13.0 x	8.6 x	7.1 x	5.4 x	4.4 x
EV / EBITDA	10.9 x	7.5 x	5.8 x	4.8 x	4.3 x
CFPS (¢)	12.0	32.4	36.5	40.1	41.6
Price / CF	22.8 x	8.4 x	7.5 x	6.8 x	6.6 x
NTA per share	$0.05	-$0.18	-$0.05	$0.12	$0.26
Pr / NTA	50.7 x	-14.8 x	-60.4 x	21.9 x	10.4 x

Profit and loss ($M)

Year ending Jun	2010	2011	2012F	2013F	2014F
Sales revenue	406.1	426.8	411.8	437.4	464.1
growth over pcp	*100.6%*	*5.1%*	*(3.5%)*	*6.2%*	*6.1%*
EBITDA	31.1	47.2	60.7	68.0	72.3
Dep'n and amort'n	(5.0)	(6.0)	(11.8)	(6.9)	(2.1)
EBITAg	**26.1**	**41.2**	**48.9**	**61.1**	**70.2**
Goodwill amortisation	0.0	0.0	0.0	0.0	0.0
EBIT	**26.1**	**41.2**	**48.9**	**61.1**	**70.2**
growth over pcp	*139.6%*	*58.0%*	*18.6%*	*25.0%*	*14.9%*
Net interest expense	(2.0)	(0.8)	(1.0)	(0.8)	(0.3)
Pre-tax profit	24.1	40.4	47.8	60.3	69.9
Tax	(8.0)	(12.8)	(14.3)	(18.1)	(21.0)
Effective tax rate	*33.3%*	*31.6%*	*30.0%*	*30.0%*	*30.0%*
Preference dividends	0.0	0.0	0.0	0.0	1.0
Minorities	0.0	0.0	0.0	0.0	0.0
Lodge adjustments	2.4	3.7	4.5	2.2	0.0
Lodge adj profit	**18.4**	**31.4**	**38.0**	**44.4**	**48.9**
Reported profit (pre sig)	16.1	27.6	33.5	42.2	48.9
One-off items (post tax)	0.0	0.0	0.0	0.0	0.0
Reported net profit	16.1	27.6	33.5	42.2	48.9

Balance sheet ($M)

Year ending Jun	2010	2011	2012F	2013F	2014F
Cash	15.1	12.5	5.3	25.8	43.8
Receivables	55.8	51.1	49.3	52.4	55.6
Inventories	0.3	0.4	0.3	0.4	0.4
Other	7.3	10.9	10.9	10.9	10.9
Current assets	**78.5**	**74.9**	**65.9**	**89.4**	**110.7**
Net PPE	3.7	3.4	7.6	7.1	6.5
Investments	0.0	0.0	0.0	0.0	0.0
Goodwill	70.5	116.6	111.3	106.3	106.3
Deferred tax assets	6.7	6.4	6.4	6.4	6.4
Other	0.1	0.0	0.0	0.0	0.0
Non-current assets	**81.0**	**126.5**	**125.3**	**119.8**	**119.2**
Total assets	**159.5**	**201.4**	**191.2**	**209.2**	**229.9**
Debt	16.6	29.7	17.1	15.7	15.7
Provisions	4.1	4.2	4.2	4.2	4.2
Other	61.8	73.7	71.7	75.1	78.7
Total liabilities	**82.5**	**107.6**	**92.9**	**95.0**	**98.6**
Equity / reserves	63.2	67.1	67.1	67.1	67.1
Retained profits	13.8	26.7	38.6	54.6	71.7
Total s/h funds	**77.0**	**93.8**	**105.6**	**121.7**	**138.8**
Minorities	0.0	(0.0)	(0.0)	(0.0)	(0.0)
Total funds emp.	**78.5**	**111.0**	**117.4**	**111.6**	**110.6**

Cashflow ($M)

Year ending Jun	2010	2011	2012F	2013F	2014F
EBIT	26.1	41.2	48.9	61.1	70.2
Net interest paid	(2.2)	(1.9)	(1.0)	(0.8)	(0.3)
Dep'n and amort'n	5.0	6.0	11.8	6.9	2.1
Tax paid	(5.9)	(4.1)	(14.3)	(18.1)	(21.0)
Gross cash from op'ns	**22.9**	**41.3**	**45.3**	**49.2**	**51.0**
(Inc) / dec in wk'g cap	(6.2)	7.8	(0.2)	0.4	0.4
(Inc) / dec in provisions	1.7	20.3	0.0	0.0	0.0
Other	(5.1)	(29.7)	0.0	0.0	0.0
Operating cashflow	**13.3**	**39.7**	**45.1**	**49.5**	**51.4**
growth over pcp					
Investing cashflows					
Capital expenditure	(0.9)	0.1	(6.0)	(1.5)	(1.5)
Asset sales	0.0	0.0	0.0	0.0	1.0
Investments	(16.3)	(43.2)	(4.9)	0.0	0.0
Divestments	0.0	0.0	0.0	0.0	0.0
Other	0.0	(1.3)	0.0	0.0	0.0
Financing cashflows					
Equity raised	20.4	1.0	0.0	0.0	0.0
Dividends paid	(8.3)	(12.1)	(21.4)	(26.2)	(31.8)
Chg in loans	**0.1**	**13.2**	**(20.0)**	**(1.4)**	**0.0**
Other non-op flows	0.0	0.0	0.0	0.0	0.0
Net chg in cash	**8.4**	**(2.5)**	**(7.2)**	**20.4**	**19.0**

Ratio analysis

Year ending Jun	2010	2011	2012F	2013F	2014F
EBITDA / sales	7.6%	11.1%	14.7%	15.6%	15.6%
EBITAg / sales	6.4%	9.7%	11.9%	14.0%	15.1%
EBIT / sales	**6.4%**	**9.7%**	**11.9%**	**14.0%**	**15.1%**
Return on assets	18.1%	21.8%	26.3%	33.3%	37.7%
Return on equity	**20.9%**	**29.5%**	**31.7%**	**34.7%**	**35.3%**
Return on funds emp.	**38.2%**	**43.5%**	**42.8%**	**53.3%**	**63.2%**
Net debt / (cash) ($M)	1.5	17.2	11.8	(10.1)	(28.1)
Debt / equity	21.5%	31.7%	16.2%	12.9%	11.3%
Net debt / equity	**2.0%**	**18.3%**	**11.1%**	**(8.3%)**	**(20.3%)**
Interest cover	13.1 x	52.3 x	46.7 x	78.8 x	217.5 x

Interims ($M) Source; Lodge Partners

MTU Half Year Split	1HY10	2HY10	1HY11	2HY11
Sales revenue	187.7	218.4	215.7	211.1
EBITDA	15.3	15.8	20.1	27.1
EBIT	**12.6**	**13.4**	**17.4**	**23.8**
Lodge adj profit	**9.5**	**8.9**	**13.1**	**18.3**
Reported profit	9.5	6.5	11.5	16.2
EBITDA / sales	8.2%	7.2%	9.3%	12.8%
EPS (¢) Adj	**8.7**	**7.9**	**10.7**	**14.9**
EPS growth on pcp	113.5%	41.8%	22.5%	88.1%
DPS (¢)	5.0	5.0	7.0	9.0
% of FY EBIT	48%	52%	42%	58%

Disclaimer

General Securities Advice Warning

Explanation of Lodge Partners recommendation system:

Recommendations are assessments of each Lodge Partners Analyst's view of potential total returns over a 1 year period relative to the performance of the Small All Ordinaries Accumulation Index.

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 relative to Small All Ordinaries Accumulation Index

Hold: Expected Total Return between 0% and 15% over a 1 year period relative to Small All Ordinaries Accumulation Index

Sell: Expected Total Return less than 0% over a 1 year period relative to Small All Ordinaries Accumulation Index

Analyst Verification

I verify that I, **Stephen Cleugh**, have prepared this research report accurately and that any financial forecasts and recommendations that are expressed are solely my own personal opinions. In addition, I certify that no part of my compensation is or will be directly or indirectly tied to the specific recommendation or financial forecasts expressed in this report.

Contact Lodge Partners:

Melbourne
Level 3, 405 Collins St
Melbourne Vic, 3000

Phone: +61 3 9618 7000
Fax: +61 3 9618 7077
www.lodgepartners.com.au

Sydney
Level 2, 2 Bligh St
Sydney NSW 2000

Phone: +61 2 9221 3277
Fax: +61 2 9221 7199