

Company Review

Ord Minnett Research

Tuesday, 30 August, 2011

M2 Telecommunications

FY11 Results

- The M2 Telecommunications (MTU) result was broadly in-line with our estimates, but included some one-off effects that made comparison difficult. EBITDA of \$48.3 (OM \$49.3) was up 54% on the pcp, but was reduced by a \$1.5m charge for doubtful debts arising from the eDirect acquisition in April 2011. Underlying NPAT of \$31.3m (OM \$30.9m) was up 68% on the pcp.
- Revenue has been rebased going forward to exclude ~\$55m in zero-margin revenue that was part of the eDirect business. Therefore, FY12 guidance is for revenue between \$380-420m, balanced by an expected increase in EBITDA margin to 15% in FY12 after one-off expenses (up from 11.3% in FY11).
- Cashflow was weaker in the 2H11 versus 1H11 due to a timing issue with some wholesale price negotiations which is expected to be resolved in 1Q12. Nevertheless, cashflow conversion was good and the balance sheet remains conservatively placed.
- An unexpected development from the result was the transition of longstanding CEO and founder Vaughan Bowen to an Executive Director role, being replaced by COO Geoff Horth. The change will take place at the AGM in October, however we expect very little to change in terms of the company's strategic direction.
- Company guidance for FY12 provides growth (at the midpoint of the range) for EBITDA of 24%, and NPAT and EPS of 15%. This has led to significant downgrades to our FY12/13 EPS estimates of 8.8% and 6.3%. Our valuation falls by 19% to \$3.43ps.
- We have downgraded our recommendation to Accumulate, noting that while we still remain positive on the stock, rapid industry change and a more competitive SMB market lead us to take a more measured approach to FY12 and beyond.

Key Financials

Year-end June (A\$)	FY10A	FY11A	FY12E	FY13E	FY14E
Revenue (\$m)	406.1	426.8	405.5	438.0	473.4
EBITDA (\$m)	31.4	48.3	60.1	70.4	74.6
Net profit after tax (\$m)	16.2	27.6	32.0	40.9	46.4
Reported EPS (¢)	14.6	22.5	26.1	33.4	37.8
P/E (x)	18.7	12.1	10.5	8.2	7.2
EV/EBITDA	10.0	7.4	5.8	4.7	4.2
Dividend (¢)	10.0	16.0	18.3	23.4	26.5
Net Yield (%)	3.7	5.9	6.7	8.6	9.7
Franking (%)	100	100	100	100	100
Normalised NPAT (\$m)	18.6	31.3	36.5	45.3	48.9
Fully Diluted Norm. EPS (¢)	16.4	25.1	29.3	36.4	39.3
EPS Growth (%)	na	53.8	16.5	24.1	8.1
Normalised P/E (x)	16.7	10.9	9.3	7.5	6.9
Relative P/E (x)	1.1	0.8	0.8	0.7	0.6
Normalised ROE (%)	24.2	33.4	35.2	39.0	37.6

Source: Iress, Company, Ord Minnett Estimates

Note: all share price data as at 29 August.

Tuesday, 30 August, 2011

MTU A\$2.73

Recommendation
Accumulate (from Buy)

Risk Assessment
High

Integrated Telecom Services

Brad Dunn

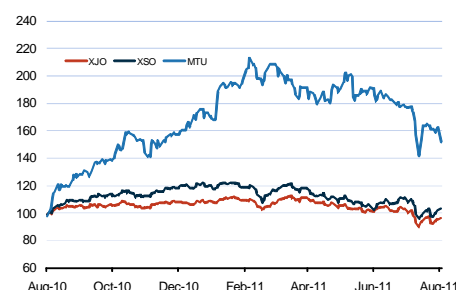
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M2 Telecommunications

ASX Code	MTU
52 week range	A\$4.08 - A\$ 1.74
Market Cap	A\$333m
Shares Outstanding	123.7m
Av Daily Turnover	A\$0.65m
ASX All Ordinaries	4333.7
ASX200 Industrials	3326.6
NTA FY11 (¢ per share)	-18.6
Net Debt FY11 (\$m)	17.2

Relative price performance



Source: Iress

Consensus earnings

	FY12E	FY13E
NPAT (C)	38.5	45.7
NPAT (OM)	36.4	45.6
EPS (C)	30.8	37.1
EPS (OM)	29.2	36.6

Source: Iress **Note:** Consensus is pre-result.

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Financial Summary

M2 Telecommunications Price: \$2.73

Recommendation: Accumulate

Profit & Loss Statement (A\$m)	FY10A	FY11A	FY12E	FY13E	FY14E
Operating Revenue	406.1	426.8	405.5	438.0	473.4
Operating Costs	374.7	378.6	345.4	367.6	398.8
Share of Associates	0.0	0.0	0.0	0.0	0.0
EBITDA	31.4	48.3	60.1	70.4	74.6
Depreciation & Amortisation	5.0	6.0	10.0	9.0	7.1
EBIT	26.4	42.3	50.2	61.4	67.5
Net Interest Expense	2.2	1.9	1.3	0.6	-0.1
Pre-Tax Profit	24.2	40.4	48.9	60.8	67.6
Tax Expense	8.0	12.8	16.9	19.9	21.2
Reported NPAT	16.2	27.6	32.0	40.9	46.4
Significant Items (After Tax)	0.0	0.0	0.0	0.0	0.0
Normalised NPAT	18.6	31.3	36.5	45.3	48.9
EBITDA Margin (%)	7.7%	11.3%	14.8%	16.1%	15.8%
Effective tax Rate (%)	33.1%	31.6%	34.5%	32.7%	31.4%
Diluted EPS (cps)	14.6	22.2	25.7	32.9	37.3
Diluted Normalised EPS (cps)	16.4	25.1	29.3	36.4	39.3
DPS (cps)	10.0	16.0	18.3	23.4	26.5
Payout Ratio (%)	68.6%	71.0%	70.0%	70.0%	70.0%
Franking (%)	100%	100%	100%	100%	100%

Cash Flow Statement (A\$m)	FY10A	FY11A	FY12E	FY13E	FY14E
EBITDA	31.4	48.3	60.1	70.4	74.6
Net Change in Working Capital	-7.2	-3.6	-0.3	-0.4	0.7
Net Interest (paid)/received	-2.0	-0.8	-1.3	-0.6	0.1
Tax Paid	-5.9	-4.1	-16.9	-19.9	-21.2
Other Operating Items	-2.1	0.0	0.0	0.0	0.0
Operating Cash Flow	13.3	39.7	41.6	49.6	54.2
Asset Sale Proceeds	0.0	0.0	0.0	0.0	0.0
Net Acquisitions	-3.8	-37.2	-4.5	0.0	0.0
Capex	-1.8	-1.2	-3.9	-4.0	-4.3
Other investing items	-11.6	5.9	0.0	0.0	0.0
Investing Cash Flow	-17.1	-32.5	-8.4	-4.0	-4.3
Inc/(Dec) in Equity	20.4	1.0	0.0	0.0	0.0
Inc/(Dec) in Borrowings	0.1	13.2	-7.0	0.0	0.0
Dividends Paid	8.3	12.1	22.3	28.5	32.3
Other Financing Items	0.0	0.0	0.0	3.0	6.0
Financing Cash Flow	12.2	2.1	-29.3	-28.5	-32.3
Net Inc/(Dec) in Cash	8.4	-2.5	3.9	17.1	17.5

Balance Sheet (A\$m)	FY10A	FY11A	FY12E	FY13E	FY14E
Cash	15.1	12.5	16.5	33.6	51.1
Inventories	0.3	0.4	0.4	0.4	0.4
Receivables	55.8	51.1	48.9	52.8	57.1
Other Current Assets	7.3	10.9	10.9	10.9	10.9
PP & E	3.7	3.4	4.8	5.2	5.6
Intangibles	70.3	116.6	113.7	108.3	105.2
Other Non Current Assets	6.8	6.4	6.4	6.4	6.4
Total Assets	159.3	201.4	201.5	217.5	236.6
Short term Debt	5.1	12.5	12.5	12.5	12.5
Other Current Liabilities	61.3	72.7	70.1	73.7	78.6
Long term Debt	11.4	17.3	10.3	10.3	10.3
Other Non Current Liabilities	4.4	5.1	5.1	5.1	5.1
Non current liabilities	15.8	22.4	15.4	15.4	15.4
Total Liabilities	82.3	107.6	98.0	101.5	106.5
Total Equity	77.0	93.8	103.5	116.0	130.1
Total liability & Shareholder equity	159.3	201.4	201.5	217.5	236.6
Net (Debt)/Cash	-1.5	-17.2	-6.3	10.8	28.4

Key Statistics	FY10A	FY11A	FY12E	FY13E	FY14E
Revenue					
Retail	251.5	257.9	245.0	269.5	296.4
Revenue Growth	na	2.6%	-5.0%	10.0%	10.0%
Wholesale	154.7	169.0	160.5	168.5	177.0
Revenue Growth	na	9.2%	-5.0%	5.0%	5.0%
Total Revenue	406.1	426.8	405.5	438.0	473.4

DuPont Analysis	FY10A	FY11A	FY12E	FY13E	FY14E
EBIT Margin	6.5%	9.9%	12.4%	14.0%	14.3%
x Asset Turnover	2.55	2.12	2.01	2.01	2.00
x Interest Burden	0.92	0.96	0.97	0.99	1.00
x Tax Burden	0.77	0.77	0.75	0.74	0.72
= Return on Assets	11.7%	15.5%	18.1%	20.8%	20.7%
x Leverage	2.1	2.1	1.9	1.9	1.8
= Return on Equity	24.2%	33.4%	35.2%	39.0%	37.6%

Largest Shareholders	shares (m)	%	Date
Hunter Hall	13.7	11.2%	Dec 09
Vaughan Bow en	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)	FY10A	FY11A	FY12E	FY13E	FY14E
Normalised EPS	16.4	25.1	29.3	36.4	39.3
Dividend Per Share	10.0	16.0	18.3	23.4	26.5
Cash Flow Per Share	12.0	32.4	33.9	40.4	44.1
NTA per share	6.0	-18.6	-8.3	6.3	20.4

Valuation Ratios (x)	FY10A	FY11A	FY12E	FY13E	FY14E
P/E Multiple	16.7	10.9	9.3	7.5	6.9
Price To Book Value	45.3	-14.7	-32.9	43.6	13.4
Price To Cash Flow	22.8	8.4	8.0	6.8	6.2
EBITDA Multiple	10.0	7.4	5.8	4.7	4.2
EBIT Multiple	11.6	8.2	6.7	5.2	4.4

Leverage	FY10A	FY11A	FY12E	FY13E	FY14E
Net Debt/Equity	2.0%	18.3%	6.1%	-9.3%	-21.8%
Net Debt/Total Assets	0.9%	8.5%	3.1%	-5.0%	-12.0%
EBIT Interest Cover (x)	11.8	22.8	39.9	103.8	-664.9

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)	176	1.45
Terminal Value	248	2.04
Net (Debt) / Cash	6	0.05
Franking Credits Value	0	0.00
Group NPV	418	3.43
Current Share Price		2.73
Relative to NPV:		20.4% Disc. to NPV

Source: Ord Minnett estimates, Company data. *Assumes taxes normalise in the forcast years.

FY11 Results

Table 1: FY11 Results Summary

	FY10A	1H11A	change pcp	FY11A	change pcp	FY12E	change pcp
Revenue	406.1	215.7	14.9%	426.8	5.1%	405.5	-5.0%
Opex	-374.7	-195.6	13.5%	-378.6	1.0%	-345.4	-8.8%
EBITDA	31.4	20.1	30.9%	48.3	53.7%	60.1	24.6%
Depn. & Amort.	-5.0	-2.7	-0.1%	-6.0	20.5%	-10.0	65.3%
EBIT	26.4	17.4	37.4%	42.3	60.0%	50.2	18.8%
Interest	-2.2	-0.8	-29.2%	-1.9	-17.5%	-1.3	-32.1%
NPBT	24.2	16.7	43.6%	40.4	67.2%	48.9	21.1%
Tax	-8.0	-5.2	52.4%	-12.8	59.5%	-16.9	32.3%
Normalised NPAT	16.2	11.5	39.9%	27.6	71.0%	32.0	15.9%
Non-operating items	2.4	1.6	14.3%	3.7	53.4%	4.5	20.5%
Reported NPAT	18.6	13.1	36.1%	31.3	68.7%	36.5	16.5%
EBITDA Margin	7.7%	9.3%		11.3%		14.8%	
EBIT Margin	6.5%	8.1%		9.9%		12.4%	
Effective Tax Rate	33.1%	31.2%		31.6%		34.5%	

Source: Company data, Ord Minnett estimates

Revenue grew only slightly on the pcp, which was unblemished by acquisition activity but nonetheless was weaker than OM expectations by 6%. Also, the benefits of reduced wholesale access prices do not show up at this line. Going forward, revenue has been rebased to exclude a large portion of revenue that was not generating margin associated with the eDirect business which was purchased in April 2011.

Operating costs were only up 1%, primarily helped by 6-months of lower wholesale access costs thanks to the ACCC decision which was backdated to 1 January 2011. Also helping was the renegotiation of wholesale pricing with major suppliers Telstra and Optus.

The combination of these factors saw **EBITDA** increase 54% on the pcp. EBITDA margins are expected to increase sharply given the rebased revenue expectation. We expect **EBITDA margins** of 14.8% in FY12, and peaking at ~16% as the benefits of several initiatives kick in from FY13 onward. These include the introduction of a new Business Support System, investment in brand consolidation, as well building the sales team further which could start to show results from 3Q12.

Depreciation is expected to increase by ~\$1m as the new business support system is activated this year and depreciated over 10 years.

Amortisation is expected to increase on FY11 levels given that more of the value of the eDirect acquisition came from customer contracts which are amortised according to the relevant accounting standards.

From an operational perspective, the key point to note is that founder and longstanding CEO Vaughan Bowen has decided to move to an Executive Director role from October 2011, to be replaced by COO Geoff Horth. Mr. Bowen will be tasked with assessing further M&A opportunities, maintaining key customer and supplier relationships and providing strategic advice to the incoming CEO.

Divisional Summary

Table 2: Divisional Summary

<i>Revenue</i>	<i>FY10A</i>	<i>1H11A</i>	<i>change pcp</i>	<i>FY11A</i>	<i>change pcp</i>
Retail	251.5	119.6	4.1%	257.9	2.6%
Wholesale	154.7	96.1	32.1%	169.0	9.2%
Divisional Revenue	406.1	215.7	14.9%	426.8	5.1%

<i>Segment NOPAT</i>	<i>FY10A</i>	<i>1H11A</i>	<i>change pcp</i>	<i>FY11A</i>	<i>change pcp</i>
Retail	17.0	8.9	-5.8%	23.0	35.5%
Wholesale	2.4	3.8	188.7%	6.4	169.7%
Segment NOPAT	19.4	12.6	17.8%	29.4	51.9%
Less: Corporate Costs	3.2	1.2		1.8	
Reported NPAT	16.2	11.5	38.0%	27.6	71.0%
Add: Income Tax	8.0	5.2		12.8	
Group NPBT	24.2	16.7	42.4%	40.4	67.2%

Source: Company data

Retail revenue (which includes all revenue from servicing SMB and retail customers under the Commander, People Telecom and Southern Cross Telco brands) remained broadly stable over the year, while NOPAT jumped quite dramatically as a result of benefits accruing from the ACCC Interim Access Determination (IAD).

Wholesale revenues fell 30% half-on-half mostly as a result of eDirect revenues being removed from 1 April 2011 (~\$15-20m effect). After adjusting for one-off effects in FY10, the wholesale division saw good NOPAT growth in FY11.

Balance Sheet and Cashflow

Acquisition activity continued during the year, with an increase in intangible assets the primary change at the asset line. Working capital requirements fell during the year, and continue to be managed conservatively. An increase in loans coming due this FY will be largely offset by a cashflow that is expected in 1Q12 in relation to re-negotiated wholesale access prices. We believe this payment to be in the range of \$7m.

Cashflow conversion was much improved on last year, and was weaker in the 2H due to the delayed receivable. If the delayed entry were to be included, cashflow conversion would have been above 100%.

Table 3: Cashflow Conversion

	<i>FY08</i>	<i>FY09</i>	<i>FY10</i>	<i>FY11</i>	<i>FY12E</i>
EBITDA	9.1	13.3	31.4	48.3	60.1
Operating Cashflow	7.3	8.3	13.3	39.7	41.5
Add back tax paid	2.2	2.8	5.9	4.1	16.9
Add back net interest	0.6	0.5	2.0	0.8	1.4
OCF pre-int and pre-tax	10.0	11.6	21.2	44.6	59.8
Cashflow to Earnings	110.2%	87.0%	67.4%	92.4%	99.4%

Source: Company data, Ord Minnett estimates

Outlook

The company has provided detailed earnings guidance for FY12, which includes revenue guidance of between \$380-420m (after excluding ~\$55m of non-margin wholesale revenues from the internalisation of the eDirect business. However, EBITDA is still expected to increase by between 20-28% to \$58-62m, while reported EPS is expected to increase 10-20% to 24-28cps.

EBITDA margins are expected to increase to 15%, which we expect to be the new baseline for margins, before accounting for expected benefits from the new business support system (internally nicknamed "Ninja"), some brand consolidation and investments to bolster sales teams.

We do not expect any appreciable change in business strategy with the transition to a new CEO, given the expected continued close involvement of the current CEO in the business after the transition takes place. The board and senior management has also been remarkably stable over the years, which also indicates a radical change of course is unlikely.

Changes to Estimates

After accounting for the various adjustments required as mentioned in this note, we make the following changes to our earnings estimates for FY12 and FY13. In FY12 EBITDA is affected by \$1.5m due to changes to the wholesale access prices effective from July 1, and \$4.5m from the combined effect of investments being made in the business.

Table 4: Changes to Estimates

	FY12E Old	FY12E New	% variance	FY13 Old	FY13 New	% variance
Revenue (\$m)	507.2	405.5	-20.1%	540.2	438.0	-18.9%
EBITDA (\$m)	67.0	60.1	-10.2%	74.2	70.4	-5.1%
EBIT (\$m)	54.8	50.2	-8.4%	67.8	62.2	-8.2%
Reported NPAT (\$m)	34.3	31.9	-6.9%	44.6	41.3	-7.4%
Normalised NPAT (\$m)	39.8	36.4	-8.6%	48.7	45.6	-6.3%
EBITDA Margin	12.6%	14.8%		13.7%	16.1%	
Fully Diluted EPS (¢)	32.0	29.2	-8.8%	39.1	36.6	-6.3%

Source: Ord Minnett estimates

Valuation and Recommendation

Given our understanding of the competitive environment and the industry changes occurring at present, we prefer to take a more cautious stance on MTU in the medium term, however we remain positive on the management and the strategy of the business. We move to an Accumulate recommendation, while looking to better understand market dynamics.

That said, following weakness in the share price yesterday the stock is now trading on an FY12E PE of 9.3x, with EPS growth of 16% expected, being the midpoint of updated guidance. The stock offers a fully franked dividend yield of 6.7% (assumed 70% payout ratio as per previous history).

Our estimate changes at the EBITDA line drive the changes to free cash flow that affect our valuation over the forecast period. This results in a downgrade to our valuation of ~19% to \$3.43 per share.

Key Risks

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.

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

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.

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.

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