



BUY - \$1.84

M2 Telecommunications (MTU)

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Strong result; one-off costs brought forward

Company Data

ASX Code	MTU
Price	\$1.84
12 month price target	\$2.24
12 month dividend yield	8.2%
Implied return	29.9%
Shares on issue	121.5m
Market cap	\$223.6m
12 Month price range	\$0.675/\$2.05
Monthly turnover	1.432m

Forecast Changes

	2011F	2012F	2013F
NPAT	-	+3.6%	-
EPS	-	+3.6%	-
DPS	-	+3.2%	-

Earnings Summary

Yr to 30 June	2010	2011F	2012F	2013F
Lodge adj profit	18.5	27.6	31.2	33.5
Rep. Profit _(pre-sia)	16.1	24.4	28.2	30.8
EPS (¢) adj	16.7	22.7	25.7	27.6
EPS growth	63.5%	38.3%	15.7%	9.3%
P/E ratio	11.0 x	8.1 x	7.2 x	6.7 x
DPS (¢)	10.0	14.0	16.0	17.5
Yield	5.4%	7.6%	8.7%	9.5%
Franking	100%	100%	100%	100%
Payout ratio	69%	70%	69%	69%
EV / EBIT	8.6 x	6.1 x	5.2 x	4.5 x
EV / EBITDA	7.2 x	5.2 x	4.6 x	4.0 x
CFPS (¢)	12.0	29.3	27.7	29.7
Price / CF	15.3 x	6.3 x	6.6 x	6.2 x
NTA per share	\$0.05	\$0.13	\$0.24	\$0.35
Pr / NTA	33.5 x	14.2 x	7.8 x	5.3 x

Share Price Chart



M2 Telecom has reported a strong FY10 profit result, albeit falling 7% short of our expectations due to higher interest expense and a 33% effective tax rate. Adjusted net profit is \$18.5m (+119%) after adding back \$2.4m worth of customer contract amortisation. Revenue of \$406m (+101%) is 4% above expectation, offset by one-off redundancy, bad debt and commission costs leading to EBITDA of \$31.4m (+136%), in line with forecasts. A final DPS of 5.0 cps was declared (FY 10.0 cps), close to the targeted 70% payout ratio.

Gaining market share- Excluding acquisition contributions, we estimate that organic revenue on the legacy businesses was \$205m (+15.4%) during FY10, driven by market share gains and new customer wins in the SME space. M2 has continued to solidify its position as a re-seller of tailored, bundled plans to SME's, leveraging its comparative advantage, namely a proven sales team and SME relationships, to win share in the space too small for the major players to operate effectively in. We expect that the main retail division will continue to post medium term organic growth in the range of 8% p.a.

Contributions from People Telecom (\$4.2m pat) and Commander (\$5.1m pat) were in line with expectations, with net margins on 5.3% and 4.3% respectively, versus the group-wide FY09 net margin of 4.0% demonstrating the accretive year 1 impact of the businesses. Cross selling and up-selling opportunities in each of the acquisitions, combined with the FY11 contribution of Clever (c\$2.3m EBITDA) and Bell Networks (c\$2m EBITDA) are also likely to drive profit accretion.

A number of one-off costs have been brought forward into FY10, relating to recent acquisitions (\$5.8m facilities costs), a greater efficiency push (redundancy costs), commission changes within the wholesale division and \$1.5m worth of write-downs on bad debts relating to a specific client contract. In spite of the deck clearing, M2 posted overall EBITDA margin expansion to 7.7% (from 6.5%) driven by early benefits of cost efficiencies and improved scale with suppliers. Synergies and cost gains are likely to be fully felt in FY11 and we expect EBITDA margins of 9.2%. We have included \$5m of capex in each of FY11 and FY12 for the new company wide billing system, to be rolled out across each division during the coming 18 months.

M2 has re-affirmed its revenue and profit guidance for FY11. Our underlying net profit forecast of \$27.6m, sits 2% above the top end of the current guidance range of \$26.7m. With excellent cash flow generation and close to zero net debt, M2 is in a strong position to further take advantage of consolidation in the small Telco space and execute accretive acquisitions. Given the nature of M2's rolling contracts, the current election state of flux is not having a noticeable effect on forward revenue projections, adding to the quality of the earnings guidance. Further, we do not believe that the presence of an NBN (or Coalition alternative) will provide a material catalyst for M2.

We retain a BUY recommendation and price target of \$2.24. At FY11f P/E of 8.1x, M2 trades at a discount to sector comparables TPG 13.0x and Amcom 10.0x.

Full Year to 30 June	FY09	FY10	% chg on pcp	
Profit and loss statement				
Sales revenue	202.5	406.1	100.6%	4% above expectations; strong organic retail division & acquisitions
EBITDA	13.1	31.4	140.2%	EBITDA in line; redundancy costs & \$1.6m bad debt provision
Depreciation	(0.6)	(1.5)	142.0%	depreciation low- asset light business model
Amortisation	(1.5)	(3.5)		
EBIT	11.0	26.1	137.7%	
Net interest expense	(0.5)	(2.0)	-331.7%	net interest expense \$350 K higher than expected
Pre-tax profit	10.5	24.1	129.2%	
Tax expense	(3.0)	(8.0)	163.4%	
Reported profit	7.5	16.1	115.3%	\$1.3m below expectations due to tax & interest expense
Significant items	0.0	0.0		
NPAT (pre sig)	7.5	16.1	115.3%	
Adjustments	0.7	2.4		amortisation of customer contracts was expected to be \$3.2m
Lodge adj profit	8.1	18.5	127.4%	Adds back non-cash amortisation of customer contracts
Tax rate (%)	28.9%	33.2%	4.3%	33% rate due to adjustment on prior yr income tax & share payments
EBITDA margin (%)	6.5%	7.7%	1.3%	cost and supply efficiencies drove margin growth over the full year.
EBIT margin (%)	5.4%	6.4%	1.0%	
EPS (adj)	9.6	16.7	72.7%	EPS growth < NPAT growth due to \$20m capital raising
DPS	5.5	10.0	81.8%	
Payout ratio	62.0%	68.9%	6.9%	consistent with 70% target payout ratio
Cash flow statement				
EBITDA	13.1	31.4	140.2%	in the absence of acquisitions, strong free cash generation in FY11
Net interest paid	(0.7)	(2.2)		
Tax paid	(2.8)	(5.9)		
Gross cash from op'tions	9.5	23.3	144.0%	
(Inc) / dec in working cap.	(1.0)	(5.0)	377.4%	controlled working capital, considering growth and a acquisitions
Other non-cash items	(0.2)	(5.0)	-2655.5%	\$3.8m deferred commission costs & \$1m pre-payments
Operating cash flow	8.3	13.3	60.0%	
Balance sheet				
Working capital (\$M)	(3.1)	1.9	-160.4%	tight working capital management
Net debt (cash) (\$M)	9.6	1.5	-84.2%	near zero net cash position
Net debt / equity	19.7%	2.0%	-90.1%	low gearing yields balance sheet capacity for acquisitions
Net interest cover	23.9	13.1	-44.9%	high interest coverage
Return on equity (%)	15.4%	20.9%	5.5%	ROE well above WACC of 12.5%
ROA (%)	8.1%	18.1%	9.9%	asset light business model

FY11 earnings drivers- Contribution of Clever Communications & Bell Networks, Synergies & Cross-Selling Opportunities between recently acquired businesses, EBITDA margin expansion from cost efficiencies, c8% organic earnings growth in the legacy businesses, recurring earnings model gives us confidence in management guidance.

Risks- \$10m billing system implementation over the coming 18 months, major Telco's such as Telstra stepping up competitive tensions in the small business space, acquisition integration.

M2 Telecommunications (MTU: \$1.84)

Mkt Cap: \$223.6m



Valuation data

Year ending Jun	2009	2010	2011F	2012F	2013F
Lodge adj profit	8.1	18.5	27.6	31.2	33.5
Reported profit	7.5	16.1	24.4	28.2	30.8
EPS_{adj} (¢)	9.6	16.7	22.7	25.7	27.6
EPS growth	26.6%	63.5%	38.3%	15.7%	9.3%
P/E ratio	19.1 x	11.0 x	8.1 x	7.2 x	6.7 x
DPS (¢)	5.5	10.0	14.0	16.0	17.5
Yield	3.0%	5.4%	7.6%	8.7%	9.5%
Franking	100.0%	100.0%	100.0%	100.0%	100.0%
Payout ratio	62%	69%	70%	69%	69%
EV / EBIT	21.2 x	8.6 x	6.1 x	5.2 x	4.5 x
EV / EBITDA	17.8 x	7.2 x	5.2 x	4.6 x	4.0 x
CFPS (¢)	9.9	12.0	29.3	27.7	29.7
Price / CF	18.6 x	15.3 x	6.3 x	6.6 x	6.2 x
NTA per share	-\$0.20	\$0.05	\$0.13	\$0.24	\$0.35
Pr / NTA	-9.2 x	33.5 x	14.2 x	7.8 x	5.3 x

Balance sheet (\$M)

Year ending Jun	2009	2010	2011F	2012F	2013F
Cash	6.7	15.1	15.7	20.9	35.7
Receivables	50.1	55.8	62.5	67.7	73.3
Inventories	2.6	0.3	0.4	0.4	0.4
Other	2.5	7.3	7.3	7.3	7.3
Current assets	61.9	78.5	85.9	96.4	116.7
Net PPE	5.1	3.7	7.5	10.7	9.5
Investments	0.0	0.0	0.0	0.0	0.0
Goodwill	70.3	70.3	72.1	69.1	66.4
Deferred tax assets	4.1	6.7	6.7	6.7	6.7
Other	0.1	0.1	0.1	0.1	0.1
Non-current assets	79.5	80.8	86.4	86.6	82.7
Total assets	141.4	159.3	172.3	182.9	199.5
Debt	16.3	16.6	11.6	6.6	6.6
Provisions	4.1	3.6	3.6	3.6	3.6
Other	72.6	62.0	68.6	73.6	79.1
Total liabilities	92.9	82.2	83.7	83.8	89.2
Equity / reserves	42.0	63.3	63.3	63.3	63.3
Retained profits	6.5	13.7	24.6	34.6	45.0
Total s/h funds	48.5	77.0	87.9	97.9	108.3
Minorities	0.0	0.0	0.0	0.0	0.0
Total funds emp.	58.1	78.5	83.8	83.5	79.2

Ratio analysis

Year ending Jun	2009	2010	2011F	2012F	2013F
EBITDA / sales	6.5%	7.7%	9.2%	9.2%	9.1%
EBITAg / sales	5.4%	6.5%	7.9%	8.2%	8.2%
EBIT / sales	5.4%	6.4%	7.9%	8.2%	8.1%
Return on assets	8.1%	18.1%	22.9%	24.8%	26.4%
Return on equity	15.4%	20.9%	27.8%	28.8%	28.5%
Return on funds emp.	24.7%	38.2%	44.1%	48.1%	53.2%
Net debt / (cash) (\$M)	9.6	1.5	(4.1)	(14.4)	(29.1)
Debt / equity	33.5%	21.5%	13.2%	6.7%	6.1%
Net debt / equity	19.7%	2.0%	(4.7%)	(14.7%)	(26.9%)
Interest cover	23.9 x	13.1 x	42.9 x	-196.7 x	-47.2 x

Profit and loss (\$M)

Year ending Jun	2009	2010	2011F	2012F	2013F
Sales revenue	202.5	406.1	455.4	493.1	534.0
<i>growth over pcp</i>	<i>85.9%</i>	<i>100.6%</i>	<i>12.1%</i>	<i>8.3%</i>	<i>8.3%</i>
EBITDA	13.1	31.4	42.0	45.6	48.4
Dep'n and amort'n	(2.1)	(5.0)	(5.9)	(5.0)	(4.9)
EBITAg	11.0	26.4	36.1	40.5	43.6
Goodwill amortisation	0.0	0.0	0.0	0.0	0.0
EBIT	11.0	26.1	35.8	40.2	43.3
<i>growth over pcp</i>	<i>44.9%</i>	<i>137.7%</i>	<i>37.2%</i>	<i>12.4%</i>	<i>7.5%</i>
Net interest expense	(0.5)	(2.0)	(0.8)	0.2	0.9
Pre-tax profit	10.5	24.1	35.0	40.4	44.2
Tax	(3.0)	(8.0)	(10.6)	(12.2)	(13.3)
<i>Effective tax rate</i>	<i>28.9%</i>	<i>33.2%</i>	<i>30.3%</i>	<i>30.2%</i>	<i>30.2%</i>
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	0.7	2.4	3.2	3.0	2.7
Lodge adj profit	8.1	18.5	27.6	31.2	33.5
Reported profit (pre sig)	7.5	16.1	24.4	28.2	30.8
One-off items (post tax)	0.0	0.0	0.0	0.0	0.0
Reported net profit	7.5	16.1	24.4	28.2	30.8

Cashflow (\$M)

Year ending Jun	2009	2010	2011F	2012F	2013F
EBIT	11.0	26.1	35.8	40.2	43.3
Net interest paid	(0.7)	(2.2)	(0.8)	0.2	0.9
Dep'n and amort'n	2.1	5.0	5.9	5.0	4.9
Tax paid	(2.8)	(5.9)	(10.6)	(12.2)	(13.3)
Gross cash from op'ns	9.5	23.0	30.3	33.2	35.7
(Inc) / dec in w/kg cap	(1.0)	(5.0)	(0.2)	(0.2)	(0.2)
(Inc) / dec in provisions	17.5	2.1	4.9	0.0	0.0
Other	(17.7)	(6.9)	0.6	0.6	0.6
Operating cashflow	8.3	13.3	35.6	33.7	36.1
<i>growth over pcp</i>					
Investing cashflows					
Capital expenditure	(0.9)	(0.9)	(5.2)	(5.2)	(1.0)
Asset sales	0.0	0.0	0.0	0.0	0.0
Investments	(9.7)	(16.3)	(11.3)	0.0	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	0.5	20.4	0.0	0.0	0.0
Dividends paid	(4.3)	(8.3)	(13.5)	(18.2)	(20.4)
Chg in loans	6.0	0.1	(5.0)	(5.0)	0.0
Other non-op flows	0.0	0.0	0.0	0.0	0.0
Net chg in cash	(0.2)	8.4	0.6	5.3	14.7

Interims (\$M)

Half yearly	1HY09	2HY09	1HY10	2HY10
Sales revenue	87.1	115.4	187.7	218.4
EBITDA	6.0	7.1	15.3	16.1
EBIT	5.0	6.0	12.7	13.4
Lodge adj profit	3.2	4.9	9.5	8.9
Reported profit	3.2	4.3	8.2	7.9
EBITDA / sales	6.9%	6.1%	8.2%	7.3%
EPS (¢)	4.1	5.6	7.5	9.2
EPS growth on pcp	45.7%	32.3%	83.3%	64.9%
DPS (¢)	2.5	3.0	5.0	5.0
% of FY EBIT	45%	55%	49%	51%

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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.

Analyst Verification

I verify that I, **Ian Munro**, 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.

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