

M2 Telecommunications Group Ltd

Issued: 30 August 2011

Strong FY12 result signals final call

MTU has reported another strong result with adjusted FY11 NPAT of \$33.8m (up 82.5%), EPS of 27.2c (UP 66.9%) and underlying EBITDA up 62.6% to 50.7m. We retain a positive view on MTU forecasting FY12 adjusted EPS of 33.7c, representing 24.1% growth. Despite surprise at the decision of founding CEO and Managing Director Vaughan Bowen to assume a new role as Executive Director we believe the stock still represents compelling value at current levels.

Y/E December		2010A	2011A	2012F	2013F
Revenue	\$m	406.1	426.8	397.0	433.4
EBITDA	\$m	31.2	50.7	66.6	73.2
NPAT - reported	\$m	16.2	30.1	37.3	41.7
NPAT – adjusted*	\$m	18.5	33.8	42.3	46.7
EPS (adj)	CPS	16.7	27.2	33.7	37.2
EPS Growth	%	72.7%	66.9%	24.1%	10.5%
PER	x	19.6	10.1	8.1	7.3
EV/EBITDA	x	12.8	7.0	5.5	4.7
DPS	c	10.0	16.0	19.5	23.5
Yield	%	3.1%	5.9%	7.1%	8.6%

Source: BGF Equities / * Earnings adjusted for non-cash amortisation expense

Underlying earnings growth of 66.9%

MTU have reported FY11 adjusted EPS of 25.3c. However, when we exclude one-off costs associated with bad debts in relation to the recently acquired Edirect business (\$1.5m), and acquisition costs in relation to the Clear Telecoms acquisition (\$2.0m), BGF estimates adjusted EPS from continuing operations to be 27.2c. This figure represents 66.9% growth on the pcp.

New CEO appointment a surprise

Founding CEO & Managing Director, Vaughan Bowen, will step down from the role in October and assume a new position as Executive Director, with current COO Geoff Horth assuming the role of CEO. Vaughan Bowen will remain hands-on with regards to the growth and direction of the business, and while the move may unnerve investors in the short-medium term we retain confidence in the existing management team and board to maintain the company's growth trajectory.

Guidance modest, but investment for growth included

FY12 guidance is for reported EBITDA of \$58 - \$62m. This includes a number of one-off costs, a significant business re-investment and a \$1.5m reduction in the previously expected ACCC pricing benefits. We estimate these costs will total \$9.5m in FY12, of which \$4.0m will represent one-off costs. When added back to company guidance this implies underlying EBITDA guidance for FY12 of \$62 - \$66, or 26% (mid-point) growth on FY11 EBITDA of \$50.7m.

Recommendation remains BUY – target price of \$4.53

We remain positive on MTU, albeit recognise that investor sentiment may have deteriorated with guidance and the management change. Despite this, we believe the stock remains cheap at current levels trading on a FY12 PER of 8.1x and a yield of 7.1% fully franked. Our price target is \$4.53 (from \$5.25) and our recommendation remains a BUY.

Recommendation: BUY
Price: \$2.73
Price Target: \$4.55
Code: MTU

Stock Data

Market Capitalisation \$337.8
 Issued Capital 123.7m
 Volume (monthly average) 5.1m
 12-month low \$1.74
 12-month high \$4.08

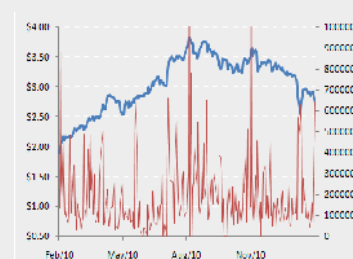
Market Data

Small Ordinaries 2486
 S&P ASX 200 4263
 All Ordinaries 4333

Valuation & Pricing Data

DCF Valuation \$4.55
 EBITDA Multiple \$4.53
 PER \$4.38

Daily Price Chart



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FY11 Results Summary

Table 1: FY11 results – BGF analysis

(\$m) – unless stated	FY10A	FY11A	% Δ	Comments
Revenues	406.1	426.8	5.1	
EBITDA - reported	31.2	47.2	51.3	<i>Includes acquisition costs & E-direct, excludes interest revenue add back one-off costs</i>
- Edirect bad debts		1.5		<i>Bad debts associated with Edirect business</i>
- Clear acquisition costs		2.0		<i>BGF estimates</i>
EBITDA - underlying	31.2	50.7	62.6	<i>Underlying EBITDA of 50.7m v BGF est. of \$51.0</i>
<i>margins (%) – underlying</i>	7.7	11.9		<i>ACCC and volumes benefits – little acquisition impact</i>
Depreciation	(2.6)	(2.3)	(13.0)	<i>Below expectations</i>
EBITA	28.5	48.4	69.8	
Amort of Intangibles	(2.4)	(3.7)	51.8	<i>Non-cash amortisation charges of acquired customer contacts</i>
EBIT	26.2	44.7	71.5	
Net Interest	(2.0)	(0.8)	(60.4)	
NPBT	24.2	43.9	82.3	
Tax	(8.0)	(13.8)	72.6	
NPAT - underlying	16.1	30.1	87.2	<i>Excludes one-off costs for Edirect & Clear Telecoms</i>
NPAT - adjusted	18.5	33.8	82.5	<i>Adjusted for amortisation of acquired customer contracts</i>
less one-off costs	-	2.0		<i>BGF estimate for Clear Telecom acquisition costs</i>
less non-cash amortisation	2.4	3.7	51.8	<i>Non-cash amortisation charges of acquired customer contracts</i>
NPAT - reported	16.1	27.6	72.0	
EPS (¢) - reported	14.6	22.5	55.4	
EPS (¢) - adjusted	16.7	27.2	65.0	<i>Cash EPS - adj. for amortisation of acquired customer contracts</i>
Dividend	10.0	16.0	60.0	<i>70% payout of reported EPS</i>

Source: Company reports & BGF Equities

Key Points:

- **Revenues** - FY11 reported revenues of \$426.8m (up 5.1%). This included \$55m of non-margin revenue in relation to the Edirect business, which was formerly a wholesale client of MTU and was acquired by MTU in March 2011. Excluding the Edirect business, 'customer revenues' of \$375m were reported for FY11 and given the assumption that Edirect generated considerably higher revenues in FY10 we estimate largely steady 'customer revenue' growth in FY11.
- **EBITDA** - underlying EBITDA of \$50.7m represented growth of 62.6% on the pcp, and we estimate organic EBITDA growth of +20% (excluding both acquisition and ACCC pricing benefits). Reported EBITDA includes the impact of \$1.5m in relation to the Edirect business for bad debts, and approximately \$2.0m in acquisition costs in relation to the Clear Telecoms acquisition (effective 1 February 2011).
- **Margin growth** - underlying EBITDA margins lifted 11.9% (pcp: 7.7%) while EBITDA margins in relation to ongoing customer revenue were 13.5% (excluding the \$55m in revenues associated with the Edirect business)
- **NPAT / EPS** - Adjusted NPAT and EPS was \$33.9m and 27.2c representing growth of 82.8% and 65% respectively. Excluding the impact of acquisitions, we estimate organic NPAT growth of +20% for FY11.
- **Cashflow** - operating cash flow was \$39.7m (pcp: 13.6m) with approximately \$7m in credits due to be received in 1H12 relating to the 2H11 operations. We expect strong ongoing cashflow to be maintained from existing operations.

FY12 Guidance

FY12 guidance is for reported EBITDA of \$58 - \$62m, which includes a number of one-off costs, a significant business re-investment and a \$1.5m reduction in the previously expected ACCC pricing benefits.

Table 2: Reported Earnings Guidance – MTU FY12

(\$m) – unless stated	FY11A	FY12F	% Δ (midpoint)	Comment
Total Revenues	426.8*	380 - 420	↓6	
Customer Revenues	375	380 - 420	↑7	
EBITDA - reported	48.3	58 - 62	↑24	<i>Reported EBITDA / Inc interest rev</i>
EBITDA % (Total Revenue)	11.3	15.0	↑33	
NPAT (reported)	27.6	30 - 34	↑15	<i>FY11 includes one-offs</i>
NPAT (adjusted)	31.3	34 - 38	↑15	
EPS (¢) (reported)	22.6	24 - 28	↑15	
EPS (¢) (adjusted)	25.3	27 - 31	↑15	

Source: MTU Telecommunications Group

Guidance for FY12 EBITDA of \$58 - \$62m is significantly below both BGF FY12 forecasts (EBITDA of \$68.6m from continuing operations) and consensus estimates which range from \$68m - \$71m.

The bridge between FY12 company guidance and previous market estimates sits within the Group's FY12 investment plans for growth. This includes a number of one-off costs in addition to an estimated \$1.5m diminishing from the financial benefit initially determined from the ACCC's recent changes to the regulated wholesale price for fixed line services. We categorise and quantify the FY12 business investment costs as follows:

Table 3: FY12 Business investment costs - ongoing & one-off

Investment / cost	Total cost (\$m)	Ongoing (\$m)	One-off (\$m)	Comment
Distribution channels	4.0	3.0	1.0	<i>Start-up & training costs of \$1m</i>
Brand consolidation	1.0	-	1.0	<i>Re-branding of People Telecom</i>
BSS implementation	2.0	-	2.0	<i>Largely redundancies</i>
ACCC price changes	1.5	1.5	-	<i>Fixed Line price ↑to \$22.84 from \$22.10</i>
Total	9.5	4.5	4.0	<i>One-off costs of \$4.0m – BGF estimates</i>

Source: Company reports / BGF estimates

Distribution channels

Management will make a significant investment in FY12 to leverage and expand the Group's established distribution channels and drive organic earnings growth. It is estimated that investment will be up to \$4.0m (with \$1.0m representing a one-off cost for initial training & retainers) and be specifically targeted to the following areas:

- New lead generation – driven by external and internal resources to drive organic growth from existing distribution channels & sales teams;
- Cross selling – lift the cross-selling capabilities of existing and new dealers to be added to MTU existing channels; and
- Dealers – increase MTU dealer numbers with an emphasis on adding 'clean skins' or experienced sales people that are new to the telecommunications industry (hence some time and financial investment will be required up front).

Brand consolidation

Management will consolidate the People Telecom brand and operations into the Commander business at an estimated cost of up to \$1m. Both the People Telecom and Commander businesses were acquired 2 years ago as challenger brands focusing on the SMB market, with Commander considered to have stronger brand awareness and distribution into this market.

BSS implementation

The Group's new BSS, named 'Ninja', will commence deployment across the Group from September 2011. Ninja will come at a cost of approximately \$9m with a pay-back target of circa 3-years. The initial roll-out in FY12 will result in redundancy costs of +\$2m.

Forecast Changes

FY12 EBITDA reconciliation – BGF Estimates

BGF EBITDA forecasts for FY12 have been revised down by \$4.5m to \$66.6m for FY12.

Our FY12 EBITDA forecast of \$66.6m assumes EBITDA from continuing operations increases by 26.4% to \$64.1m (previously \$68.6m), before the impact of our acquisition assumptions which add an additional \$2.5m and increase our FY12 EBITDA forecast to \$66.6m. The \$66.6m estimate excludes the \$4.0m in one-off costs as tabled below.

Table 4: BGF FY12 revised earnings reconciliation

(\$m) – unless stated	(\$m)	(\$m)	Comments
FY12 EBITDA - previous			
- continuing operations	68.6		
- acquisition assumptions	2.5		<i>BGF assumptions only – not MTU</i>
Total FY12 EBITDA - previous		71.1	<i>Previous BGF forecasts – FY12</i>
less			
- ongoing investment costs	(3.0)		<i>Distribution channels – permanent impact</i>
- ACCC pricing adjustments	(1.5)	(4.5)	<i>Permanent impact</i>
FY12 EBITDA revised - BGF		66.6	<i>Excludes one-off costs</i>
Less one-off costs			
- BSS redundancies	(2.0)		
- Brand consolidation	(1.0)		
- Business investment - channels	(1.0)	(4.0)	<i>FY12 one-off costs – BGF estimates</i>
FY12F EBITDA reported - BGF		62.6	<i>Includes acquisition assumptions</i>
Less acquisition assumptions		(2.5)	<i>Acquisition assumptions - BGF</i>
FY12F EBITDA - reported		60.1	<i>Comparative estimate v MTU guidance</i>

Source: Company reports & BGF estimates

Revised forecasts – FY12 & FY13

Revenues for FY12 and FY13 no longer include the Edirect impact; hence revenue growth for FY12 is based off FY11 customer revenues of \$375 plus BGF acquisition assumptions.

Our revised earnings forecasts for FY12 and FY13 largely reflect the impact of the ongoing investment in the distribution channels of \$3.0m and the ACCC pricing reduction of \$1.5m.

As a result our revised adjusted EPS forecasts for FY12 and FY13 are 33.7c and 37.3c respectively.

Our forecasts also retain acquisition assumptions for acquired EBITDA of \$5.0m based on an acquisition multiple of 3.5x EV/EBITDA, with consideration paid in cash and the transaction effective 1 January 2012.

Table 5: BGF FY12 revised earnings reconciliation

(\$m) – unless stated	FY12F			FY13F		
	Old	New	% Δ	Old	New	% Δ
Revenues	556.8	397.0	(28.7)	600.0	433.4	(27.8)
EBITDA - underlying	71.1	66.6	(6.8)	77.7	73.2	(5.8)
EBITA	67.2	62.6	(6.8)	73.8	68.6	(6.9)
EBIT	62.2	57.6	(7.4)	68.8	63.6	(7.5)
NPAT – adjusted	45.3	42.3	(6.6)	49.9	46.7	(6.4)
One-off costs	0.0	(2.8)	-	0.0	0.0	-
NPAT - reported	40.3	34.5	(14.3)	44.9	41.7	(7.1)
EPS (¢) - reported	32.1	27.9	(13.1)	35.8	33.7	(5.8)
EPS (¢) - adjusted	36.1	33.7	(6.6)	39.8	37.2	(6.4)
Dividend (¢)	23.0	19.5	(15.2)	26.0	23.5	(9.6)

Source: Company reports & BGF estimates

Disclosure: The author holds an interest in the securities of M2 Telecommunications Ltd

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