

M2 Telecommunications



Record FY10 NPAT and another dialed in!

M2 Telecommunications has delivered a record result with FY10 NPAT of \$16.2m, up 119% on the pcp, and record EPS of 14.6cps, up 66% on the pcp. The result was underpinned by the successful integration of People Telecom and the small business assets of Commander Communications. Management has flagged FY11 to be another strong period for MTU providing guidance for FY11 EPS growth of 24.3% to 33.2%.

Key Financial Information

Y/E June		2009A	2010A	2011F	2012F
Revenue	\$m	202.5	406.1	443.4	461.1
EBITDA	\$m	13.1	31.1	41.5	44.9
Reported NPAT	\$m	7.4	16.2	23.1	26.8
Normalised NPAT ¹	\$m	8.2	18.5	26.3	29.0
Normalised EPS ²	CPS	9.7	16.7	21.6	23.8
EPS Growth ²	%	34.0	72.7	29.5	10.1
PER	x	20.6	11.9	9.2	8.4
EV/EBITDA	x	17.2	7.8	5.9	5.4
DPS	c	5.5	10.0	13.0	15.0
Yield	%	2.8	5.0	6.5	7.5

Source: Company data & Balnave estimates / ¹ Pre amortisation or significant items

Strong earning and stronger normalised earnings

MTU have reported FY10 EBITDA of \$31.1m, up 138% on the pcp. However we estimate an even stronger normalised result given reported EBITDA was adversely impact by the deferral of \$2m worth of commission revenue due a change in the accounting treatment of commissions, in addition to one-off restructuring costs of \$1m in relation to recent acquisitions.

Acquisitions remain on the agenda

We anticipate that MTU's strong FY11 growth profile will also be supported by acquisition growth with management flagging that it is well positioned to target "material acquisition opportunities" that would ideally be able to add revenues of a size larger than more recent bolt-on acquisition. With the balance sheet currently in a net cash position, MTU has significant capacity for acquisition growth.

Election outcome and NBN

While management recognise the potential opportunities the NBN build, including the establishment of a pure independent wholesale provider, MTU remains 'network agonistic' with regards to the wholesale supply of telecommunications services from network providers.

Recommendation: BUY– price target \$2.70.

We rate MTU an attractive investment proposition trading on strong fundamentals that include a FY11 PER of 9.2x, normalised EPS growth of 29.5% and a dividend yield of 6.5%, fully franked. Our target price of \$2.70 per share represents 35% upside to the current price.

BUY

Price: A\$1.99

Code: MTU

Stock Data

Market Capitalisation	\$241.1m
Issued Capital	121.5m
Volume (monthly average)	2.6m
12-month low	\$1.15
12-month high	\$2.05

Market Data

Small Ordinaries	2412.7
S&P ASX 200	4567.8
All Ordinaries	4590.8

Valuation & Pricing Data

DCF Valuation	\$2.70
EBITDA Multiple	\$2.28
PER Relative	\$2.53
12 Month price Target	\$2.70

Share Price Drivers

Acquisitions	↑
Results	↑
Dividends	↑
NBN	↑↓

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FY10 RESULTS

Table 1: Interim results analysis

(\$m) – unless stated	FY09	FY10	% Δ	Comment
Revenues	202.5	406.1	100.6	<i>Largely acquisition driven</i>
EBITDA	13.1	32.2	138.3	<i>Acquisitions / includes one-off costs of ~\$1m</i>
EBIT	10.9	26.2	140.4	
Net Interest Exp.	(0.5)	(2.0)	331.7	
Tax Expense	(3.0)	(8.0)	163.4	<i>Effective tax rate of 33% due to timing & temporary differences; pcp 30%</i>
NPBT	10.5	24.2	132.0	
NPAT - reported	7.4	16.2	119.0	<i>Impacted by higher amortisation charge</i>
NPAT – normalised	8.2	18.5	127.4	<i>Add back of non-cash cost \$2.4m of customer amortisation charges</i>
EPS – reported	8.8	14.6	65.5	
EPS - normalised	9.9	16.7	68.7	

Source: Company reports & Balnave Securities estimates

Key financial highlights include:

- **EBITDA** – reported EBITDA of \$31.1m, representing growth 138.3%. Despite the strong reported result, EBITDA was adversely impacted by the one-off deferral of \$2m in commission revenue to a change in the accounting treatment of commissions which will now be recognised over FY11 and FY12. In addition, one-off restructuring costs in relation to recent acquisitions of approximately \$1m also dragged on the reported EBITDA result. We estimate that excluding those one-off impacts that normalised EBITDA was approximately \$34.1m, representing normalised growth of 168%.
- **Margin expansion.** Reported EBITDA margins have lifted to 7.7%, up from 6.5% in the pcp. We note that reported 2H10 EBITDA margins of 7.3%, 1H10 8.1%, were impacted by the recognition of one-off deferral in commission revenue of \$2m.
- **EPS growth.** Normalised EPS growth of 72.7%, which in addition to one-off impacts listed above, was adversely impacted by an effective tax rate of 33% (pcp:30%) relating to one-off timing & temporary adjustments.
- **Gearing.** As at 30 June 2010 MTU had negligible net debt of \$1.5m, and has since moved to a net cash position providing significant capacity for further acquisitions.
- **Dividend.** A final dividend of 5cps, lifting the FY10 dividend to 10cps representing a sustainable payout ratio of 69% on reported EPS.



SEGMENTED RESULTS SUMMARY

RETAIL

Table 2: FY10 Retail results

(\$m) - unless stated	FY09	FY10	Comment
Revenues			
External customers	112.2	251.5	
Intercompany sales		24.9	
Total revenues	112.2	276.4	<i>Impact of acquisitions</i>
NPAT – reported¹	4.6	17.0	<i>Acquisitions & +’ve re-allocation of overheads</i>
Margins – reported¹	4.1%	6.1%	

Source: Company reports / 1. Pre unallocated corporate overheads

Segmented NPAT (pre-unalloc.) lifted by 269.6% to \$17.0m as the impact of the People Telecom and Commander acquisitions took effect, in addition to ongoing operational efficiencies.

We estimate that \$1.0m in one-off costs (pre-tax) incurred during FY10 in relation to restructuring due to recent acquisitions were attributable to the retail operations.

WHOLESALE

Table 3: FY10 Wholesale results

(\$m) - unless stated	FY09	1FY0	Comment
Revenues			
External customers	90.3	154.7	New customers / organic growth
Intercompany sales	0.3	3.3	
Total revenues	90.6	158.0	
NPAT – reported¹	4.6	2.4	<i>Commissions & -’ve re-allocation of overheads</i>
Margins – reported¹	5.1%	1.5%	

Source: Company reports / 1. Pre unallocated corporate overheads

Segmented NPAT (pre-unalloc.) fell by 49% to \$2.4m largely as a result of a change in the accounting treatment of commissions which has resulted in approximately \$2.0m of commissions being deferred for FY10. Those commissions likely to be realised over FY11 and FY12.

In addition the wholesale operation has been impacted by an unfavourable reallocation of overhead costs in favour of retail operations, while the transfer of a licensee partner from retail to wholesale accounts for a large percentage of the revenue increase in wholesale on the pcp.



FY11 FORECASTS CHANGES

Table 4: Financial forecasts

(\$m) – unless stated	FY11F previous	FY11F revised	% Δ	% Δ on FY10A	Comment
Revenues	431.9	443.4	2.7	9.2	Top end of guidance for \$425 to \$445
EBITDA	42.7	41.5	(2.4)	33.3	Modest pullback - within guidance 41.0 to 42.5
EBITDA (%)	9.9	9.4			Less aggressive – see 1H10 trend to confirm uplift emerging
D & A	(5.0)	(6.7)	34.0	33.6	Capex uplift of \$3.5m for new Business Support System (BSS)
EBIT	36.8	34.8		33.2	
Net Interest Exp.	(0.7)	(1.9)	171.4	(6.2)	Reflects increased spend for new 'BSS'
NPBT	36.1	33.0	(8.6)	36.5	
NPAT - reported	25.3	23.1	(8.6)	43.0	Reflects modest EBITDA pull back & 'BSS' capex spend
NPAT – normalised	28.3	26.3	(8.6)	29.0	As above
EPS – reported	20.6	19.0	(7.7)	30.5	As above
EPS - normalised	23.1	21.6	(6.5)	59.5	As above
DPS	14.5	13.0	(10.3)	30.0	Reflects FY09 payout ratio of 69%

Source: Company Reports & Balnave Securities estimates

Key FY11 assumptions include:

- **EBITDA** – EBITDA of \$41.5m, up 33%, which includes new EBITDA of \$4.3m from the recent Bell Networks and Clever acquisitions, the benefit of cycling \$1m in one-off restructuring costs and the pull through of approximately \$1m of the \$2m in commissions deferred in FY10.

Margins - we have taken a less aggressive view on margins which has resulted in a modest 2.4% pull back to our previous FY11 EBITDA forecast of \$47.2m.

- **Depn & Amort** – with management confirming the implementation of their new Business Support System we have increased FY11 and FY12 capex by \$4.5m and \$3.5m respectively which is the catalyst for the increase in our depreciation forecast.
- **EPS & DPS** – we have forecast normalised FY11 EPS of 21.6cps which represents 29.5% EPS growth on the pcp. Nevertheless we have reduced our FY11F EPS by 6.5% largely as a result of the increase in our depreciation forecast. A FY11F dividend of 13cps represents a 69% payout ratio which is in line with the pcp.



FINANCIAL SUMMARY

M2 Telecommunications Group	Price	\$ 1.99								
	Market Cap	\$ 241.9								
					Year end 30 June					
Profit & Loss (\$m)	2009A	2010A	2011F	2012F	Valuation ratios	2009A	2010A	2011F	2012F	
Sales Revenue	202.5	406.1	443.4	461.1	EPS (cps)	8.8	14.6	19.0	22.0	
EBITDA	13.1	31.2	41.5	44.9	EPS (cps) - normalised	9.7	16.7	21.6	23.8	
Depn & Amort	1.4	2.6	3.5	3.5	PER (x)	20.6	11.9	9.2	8.4	
Amort - Identifiable Intangibles	0.8	2.4	3.2	2.2	PER Rel - All Ind.	45%	-19%	-26%	-25%	
EBIT	10.9	26.2	34.8	39.2	PER Rel - Small Ind.	44%	-14%	-21%	-21%	
Net Interest Expense	-0.5	-2.0	-1.9	-1.0	Enterprise Value (\$m)	225.4	243.4	243.9	242.0	
NPBT	10.4	24.2	33.0	38.2	EV / EBITDA (x)	17.2	7.8	5.9	5.4	
Tax expense	-3.0	-8.0	-9.9	-11.4	EV / EBIT (x)	20.7	9.3	7.0	6.2	
NPAT - reported	7.4	16.2	23.1	26.8	DPS (cps)	5.5	10.0	13.0	15.0	
NPAT - norm. (pre Amort Int)	8.2	18.5	26.3	29.0	Dividend Yield (%)	2.8%	5.0%	6.5%	7.5%	
+/- Significant Items	0.0	0.0	0.0	0.0	Franking (%)	100%	100%	100%	100%	
Underlying NPAT - normalised	8.2	18.5	26.3	29.0	CFPS (cps)	9.9	12.0	20.5	23.8	
					P / CFPS (x)	20.2	16.6	9.7	8.4	
Cash Flow (\$m)	2009A	2010A	2011F	2012F	Profitability ratios	2009A	2010A	2011F	2012F	
Operating EBITDA	13.1	31.2	41.5	44.9	EBITDA Margin (%)	6.5	7.7	9.4	9.7	
- Interest & Tax Paid	3.5	10.0	11.7	12.4	EBIT Margin (%)	5.4	6.4	7.9	8.5	
+/- change in Work. Cap.	0.3	-6.2	-0.7	-0.1	ROE (%)	15.2	21.0	27.0	28.1	
- other	1.5	1.7	4.1	3.5	ROA (%)	8.1	18.1	22.8	24.6	
Operating Cashflow	8.3	13.3	24.9	28.9	ROIC (%)	21.4	29.9	33.2	32.6	
- Capex	-0.9	-0.9	-8.0	-7.0	Balance Sheet ratios	2009A	2010A	2011F	2012F	
- other	0.0	0.0	-3.1	-3.0	Net Debt (cash)	9.6	1.5	cash	cash	
- equity	-9.7	-16.3	0.0	0.0	Net Gearing (%)	19.8	2.0	cash	cash	
Free Cashflow	-2.4	-3.8	13.8	18.9	Interest Cover (x)	28.4	15.7	22.3	cash	
- Ord Dividends	-4.3	-8.3	-14.6	-17.0	NTA per share (\$)	0.0	0.0	0.0	0.0	
- Equity /other	0.5	20.4	0.0	0.0	Price / NTA (x)	-18.8	6.7	16.4	27.1	
Net Cashflow	-6.2	8.3	-0.8	1.9	FFPOWA (m)	84.2	110.9	121.5	121.5	
Cash at beginning of period	6.9	6.7	15.1	9.3	Growth ratios	2009A	2010A	2011F	2012F	
+/- borrowings / other	6.0	0.1	-5.0	0.0	Sales revenue (\$m)	85.8%	100.6%	9.2%	4.0%	
Cash at end of period	6.7	15.1	9.3	11.2	EBITDA (\$m)	47.8%	138.3%	33.3%	8.2%	
					EBIT (\$m)	43.6%	140.4%	33.2%	12.4%	
Balance Sheet	2009A	2010A	2011F	2012F	NPAT (\$m)	43.0%	119.0%	43.0%	15.8%	
Cash	6.7	15.1	9.3	11.2	EPS adj. (cps)	34.0%	72.7%	29.5%	10.1%	
Inventories	1.4	0.3	0.4	0.5	DPS (cps)	10.0%	81.8%	30.0%	15.4%	
PP&E	5.0	3.7	9.1	14.3	Interim Analysis	1H10A	2H10A	1H11F	2H11F	
Debtors	49.3	55.8	59.9	62.2	Revenues	187.7	218.4	220.2	223.1	
Intangibles	67.2	70.3	69.4	68.4	EBITDA	15.3	15.9	20.7	20.8	
Other assets	11.7	14.1	14.1	14.1	EBITDA margin (%)	8.1%	7.3%	9.4%	9.3%	
Total Assets	141.3	159.3	162.1	170.7	EBIT	12.6	13.6	19.0	15.8	
Borrowings	16.3	16.6	11.3	11.3	EPS (adj)	8.7	9.7	12.2	12.2	
Trade Creditors	55.1	54.2	57.6	59.9	DPS	5.0	5.0	6.0	7.0	
Other Liabilities	21.6	11.5	7.4	3.9	Valuation	2011F				
Total Liabilities	92.9	82.3	76.4	75.2	Normalised EBITDA multiple (x)		41.5			
NET ASSETS	48.4	77.0	85.8	95.5	Target EBITDA multiple (x)		6.9			
					Net Debt (cash) (\$m)		2.0			
Board of Directors / Substantial Shareholders					Implied Valuation		284.5			
Name					Per Share		2.28			
	Shareholding	%								
Craig Farrow - Chairman	1.0	0.8%		Target PE Multiple						
Vaughan Bowen - CEO/MD	10.9	9.0%		EPS (c)	21.6					
Max Bowen - Non-Executive Director	0.0	0.0%		PER Target (x)	11.7					
Dennis Basheer - Non Executive Director	5.0	4.1%		Per Share	2.53					
John Hynd - Non Executive Director	2.8	2.3%		Discounted Cash Flow						
Michael Simmons - Non-Executive Director	0.0	0.0%		Cost of equity	15.7%	WACC	15.4%			
				Cost of debt	7.5%	Terminal Growth Rate	3.0%			
Substantial Shareholders					Net Debt/ Net debt + equity	1.9%	Per Share	2.70		
	Shareholding	%								
Hunter Hall	13.2	10.8%		Top 20 Shareholders	71.7 59.0%					
Vaughan Bowen	10.9	9.0%								
National Australia Bank	8.6	7.1%								



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Stock Recommendations:

BUY - Minimum expected upside is 20% over 12 months.

ACCUMULATE – Minimum expected upside over 12 months is below 20% but above 10% over 12 months.

HOLD - Expected upside is below 10% over 12 months.

REDUCE - Applied when there is expected downside on the stock over 12 months.

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