

# Company Review

Ord Minnett Research

Friday, 3 September, 2010

## M2 Telecommunications

### FY10 Result

- M2 Telecom (MTU) reported a sharp rise in NPAT, up 119% to \$16.2m (OMLf \$16.1m), on revenue of \$406.1m. The growth was primarily driven by the first full year contributions of Commander and People Telecom, which were both acquired late in FY09.
- After accounting for revenue growth via acquisition, revenue grew organically by 6.6% in FY10, above the industry average of ~3%.
- MTU's Retail division, which now houses Commander and People Telecom, reported segment profit of \$17.0m, while the Wholesale division saw segment profit fall from \$4.6 to \$2.4m due to accounting changes and revenue reclassifications (see Table 4).
- The task of integrating Commander and People into MTU is mostly complete, with synergy benefits contributing to strong guidance for FY11. They have a combined sales force of 400-500 people on the ground, giving them a strong physical presence.
- The company is essentially net cash following a \$20m equity raising in May 2010. Gearing (ND / ND +E) was 1.9% at 30 June, with EBIT interest cover of 11.8x. Funds raised were used in part to make 2 small acquisitions during the fiscal year which OM expects to contribute ~\$4m in EBITDA in FY11.
- MTU can increasingly use its scale to negotiate more favourable access agreements with its key suppliers (Telstra, Optus primarily), a power we expect it to continue to use in FY11 to drive improvements in profitability. Investment of \$10m over two years in new business support software will also drive efficiency gains starting in FY12.
- We maintain our Accumulate recommendation and our revised valuation is \$2.35.

#### Key Financials

Year-end June (A\$)	FY09A	FY10A	FY11E	FY12E
Revenue (\$m)	202.7	406.1	425.8	447.8
EBITDA (\$m)	13.3	31.4	41.2	48.4
NPAT (\$m)	7.5	16.2	22.9	25.9
EPS (cps)	8.9	14.6	18.8	21.3
P/E	22.6	13.8	10.7	9.4
EV/EDITDA	13.9	7.3	6.0	5.2
Dividend (¢)	5.5	10.0	13.2	14.9
Net Yield (%)	2.7	5.0	6.6	7.4
Franking (%)	100	100	100	100
Normalised NPAT (\$m)	8.9	18.6	26.1	30.2
Fully Diluted Norm. EPS (¢)	10.2	16.4	21.5	24.8
EPS Growth (%)	na	59.7	31.2	15.8
Normalised P/E	19.6	12.3	9.4	8.1
Relative P/E (x)	1.2	0.8	0.7	0.7
Normalised ROE (%)	18.4	24.2	31.1	32.9

Source: IRESS, Company, Ord Minnett Estimates. Note: all data as at 2 September 2010

MTU Last A\$2.05

Recommendation  
**Accumulate (High Risk)**

#### Integrated Telecom Services

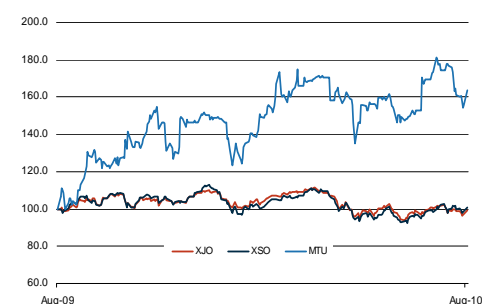
 Brad Dunn  
 Analyst

[bdunn@ords.com.au](mailto:bdunn@ords.com.au)

#### M2 Telecommunications

ASX Code	MTU
52 week range	A\$2.05 - A\$ 1.12
Market Cap	A\$244 m
Shares Outstanding	121.5m
Av Daily Turnover	A\$0.21m
ASX All Ordinaries	4406.1
ASX200 Industrials	3442.7
NTA FY10 (¢ per share)	6.0
Net Debt FY10 (\$m)	-1.5

#### Relative price performance



Source: IRESS

#### Consensus vs Ord Minnett Earnings

	FY11E	FY12E
NPAT(C)*	-	-
NPAT (OM)	-	-
EPS (C)*	-	-
EPS (OM)	-	-

Source: Thomson Financial Note: no coverage

## Financials

### M2 Telecommunications

Price: \$2.05

Recommendation: Accumulate

Profit & Loss Statement (A\$m)	FY09A*	FY10A	FY11E	FY12E
Operating Revenue	202.7	406.1	425.8	447.8
Operating Costs	189.4	374.7	384.5	399.4
Share of Associates	0.0	0.0	0.0	0.0
<b>EBITDA</b>	<b>13.3</b>	<b>31.4</b>	<b>41.2</b>	<b>48.4</b>
Depreciation & Amortisation	2.1	5.0	6.1	8.9
<b>EBIT</b>	<b>11.2</b>	<b>26.4</b>	<b>35.2</b>	<b>39.5</b>
Net Interest Expense	0.7	2.2	2.5	2.5
<b>Pre-Tax Profit</b>	<b>10.5</b>	<b>24.2</b>	<b>32.7</b>	<b>37.0</b>
Tax Expense	3.0	8.0	9.8	11.1
Reported NPAT	7.5	16.2	22.9	25.9
<b>Significant Items (After Tax)</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>
<b>NPAT (Pre-Significant Items)</b>	<b>7.5</b>	<b>16.2</b>	<b>22.9</b>	<b>25.9</b>
EBITDA Margin (%)	6.6%	7.7%	9.7%	10.8%
Effective tax Rate (%)	28.9%	33.1%	30.0%	30.0%
Diluted EPS (cps)	<b>8.6</b>	<b>14.2</b>	<b>18.8</b>	<b>21.3</b>
EPS Pre Significant Items (cps)	<b>8.6</b>	<b>14.2</b>	<b>18.8</b>	<b>21.3</b>
DPS (cps)	5.5	10.0	13.2	14.9
Payout Ratio (%)	62.0%	68.6%	70.0%	70.0%
Franking (%)	100%	100%	100%	100%

Cash Flow Statement (A\$m)	FY09A*	FY10A	FY11E	FY12E
EBITDA	13.3	31.4	41.2	48.4
Change in Working Capital	5.7	-7.2	-7.6	-6.9
Net Interest (paid)/received	-0.5	-2.0	-2.5	-2.5
Tax Paid	-2.8	-5.9	-9.8	-11.1
Other Operating Items	0.0	-2.1	0.0	0.0
<b>Operating Cash Flow</b>	<b>8.3</b>	<b>13.3</b>	<b>21.3</b>	<b>27.9</b>
Asset Sale Proceeds	0.0	0.0	0.0	0.0
Net Acquisitions	-9.1	-3.8	0.0	0.0
Capex	-0.9	-1.8	-9.3	-9.2
Other investing items	-0.6	-11.6	0.0	0.0
<b>Investing Cash Flow</b>	<b>-10.7</b>	<b>-17.1</b>	<b>-9.3</b>	<b>-9.2</b>
Inc/(Dec) in Equity	0.5	20.4	0.0	0.0
Inc/(Dec) in Borrowings	8.0	20.9	0.0	0.0
Dividends Paid	4.3	8.3	16.0	18.1
Other Financing Items	0.0	0.0	0.0	0.0
<b>Financing Cash Flow</b>	<b>2.2</b>	<b>12.2</b>	<b>-16.0</b>	<b>-18.1</b>
<b>Net Inc/(Dec) in Cash</b>	<b>-0.2</b>	<b>8.4</b>	<b>-4.0</b>	<b>0.6</b>

Balance Sheet (A\$m)	FY09A*	FY10A	FY11E	FY12E
Cash	6.7	15.1	11.1	11.6
Inventories	2.6	0.3	0.3	0.3
Receivables	50.1	55.8	61.8	67.5
Other Current Assets	2.5	7.3	7.3	7.3
PP & E	5.1	3.7	11.5	16.1
Intangibles	70.3	70.3	65.7	61.4
Other Non Current Assets	4.2	6.8	6.8	6.8
<b>Total Assets</b>	<b>141.4</b>	<b>159.3</b>	<b>164.6</b>	<b>171.1</b>
Short term Debt	3.1	5.1	5.1	5.1
Other Current Liabilities	70.4	61.3	59.8	58.6
Long term Debt	13.1	11.4	11.4	11.4
Other Non Current Liabilities	6.2	4.4	4.4	4.4
<b>Non current liabilities</b>	<b>19.3</b>	<b>15.8</b>	<b>15.8</b>	<b>15.8</b>
<b>Total Liabilities</b>	<b>92.9</b>	<b>82.3</b>	<b>80.8</b>	<b>79.5</b>
<b>Total Equity</b>	<b>48.5</b>	<b>77.0</b>	<b>83.8</b>	<b>91.6</b>
Total liability & Shareholder equity	141.4	159.3	164.6	171.1
Net (Debt)/Cash	-9.6	-1.5	-5.5	-4.9

Key Statistics	FY09A	FY10A	FY11E	FY12E
<b>Revenue</b>				
Retail	112.4	251.5	265.3	282.6
Revenue Growth		123.6%	5.5%	6.5%
Wholesale	90.3	154.7	160.4	165.2
Revenue Growth		71.3%	3.7%	3.0%
<b>Total Revenue</b>	<b>202.7</b>	<b>406.1</b>	<b>425.8</b>	<b>447.8</b>

DuPont Analysis	FY09A	FY10A	FY11E	FY12E
EBIT Margin	5.5%	6.5%	8.3%	8.8%
x Asset Turnover	1.43	2.55	2.59	2.62
x Interest Burden	0.94	0.92	0.93	0.94
x Tax Burden	0.71	0.67	0.70	0.70
= Return on Assets	5.3%	10.1%	13.9%	15.1%
x Leverage	2.9	2.1	2.0	1.9
= Return on Equity	15.4%	21.0%	27.3%	28.3%

Largest Shareholders	shares (m)	%	Date
Hunter Hall	13.2	10.9%	Dec 09
Vaughan Bowen	10.9	9.0%	Dec 09
Pengana	8.6	7.1%	Dec 09
Dennis Basheer	5.0	4.2%	Dec 09

Per Share Ratios (A\$ cents)	FY09A	FY10A	FY11E	FY12E
Normalised EPS	10.2	16.4	21.5	24.8
Dividend Per Share	5.5	10.0	13.2	14.9
Cash Flow Per Share	9.9	12.0	17.6	23.0
NTA per share	-25.8	6.0	14.9	24.9

Valuation Ratios (x)	FY09A	FY10A	FY11E	FY12E
P/E Multiple	20.0	12.5	9.6	8.3
Price To Book Value	-7.9	34.0	13.7	8.2
Price To Cash Flow	20.8	17.1	11.7	8.9
EBITDA Multiple	14.2	7.5	6.2	5.3
EBIT Multiple	15.1	8.7	7.1	6.3

Leverage	FY09A	FY10A	FY11E	FY12E
Net Debt/Equity	19.7%	2.0%	6.5%	5.4%
Net Debt/Total Assets	6.8%	0.9%	3.3%	2.9%
EBIT Interest Cover (x)	15.6	11.8	14.1	15.9

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)	93	0.76
Terminal Value	198	1.63
Net (Debt) / Cash	10	0.08
Franking Credits Value	0	0.00
Group NPV	282	<b>2.35</b>
Current Share Price		2.05
Relative to NPV:		12.8% Disc. to NPV

Source: Ord Minnett estimates, Company data. \*Note: FY09 financials have been revised following completion of acquisitions.

## FY10 Result

**Table 1: Summary of FY10 Result**

	FY09A	1H10A	FY10A	change pcp	FY11E	change pcp
Revenue	202.7	187.7	406.1	100.3%	425.8	4.8%
Opex	-189.4	-172.3	-374.7	97.8%	-384.5	2.6%
EBITDA	13.3	15.3	31.4	135.6%	41.2	31.3%
Depn. & Amort.	-2.1	-2.7	-5.0	138.3%	-6.1	21.8%
EBIT	11.2	12.7	26.4	135.1%	35.2	33.1%
Interest	-0.7	-1.1	-2.2	nm	-2.5	10.8%
NPBT	10.5	11.6	24.2	129.8%	32.7	35.2%
Tax	-3.0	-3.4	-8.0	163.4%	-9.8	22.3%
Reported NPAT	7.5	8.2	16.2	116.1%	22.9	41.6%
Non-operating items	0.0	1.4	2.4	-	3.2	-
Underlying NPAT	7.5	9.6	18.6	148.2%	26.1	40.5%
EBITDA Margin	6.6%	8.2%	7.7%		9.7%	
EBIT Margin	5.5%	6.8%	6.5%		8.3%	
Effective Tax Rate	28.9%	29.4%	33.1%		30.0%	

Source: Company data, Ord Minnett estimates

Revenue more than doubled on the previous corresponding period (pcp), driven mainly by acquired revenue. After accounting for Commander and People Telecom, revenue grew by 6.6%, still more than twice the industry average.

**Table 2: Revenue Breakdown**

	\$m	\$m	% growth pcp
FY09 Revenue	202.7		
Commander		110.0	
People Telecom		80.0	
Organic Growth		13.4	6.6%
FY10 Revenue		406.1	

Source: Company data, Ord Minnett estimates

OM believes most of this organic growth was driven by the acquired brands as these are now the flagship brands and have most of the marketing budget aimed toward them. The M2 brand is being phased out on the retail side and Southern Cross Telco has a regional focus.

Non-operating items are non-cash costs to account for amortisation associated with the acquisition of customer contracts acquired in the previous period. This item comprises mainly of commission payments to aligned dealers and other costs of customer acquisition such as subsidised handsets for mobile contracts.

## Divisional Results

**Table 3: Divisional Results Summary**

<i>Revenue</i>	<b>FY09A</b>	<b>FY10A</b>	<b>change pcp</b>	<b>FY11E</b>	<b>change pcp</b>
Retail	112.4	251.5	123.7%	265.3	5.5%
Wholesale	90.3	154.7	71.3%	160.4	3.7%
Divisional Revenue	202.7	406.1	100.4%	425.8	4.8%

<i>Segment EBT</i>	<b>FY09A</b>	<b>FY10A</b>	<b>change pcp</b>	<b>FY11E</b>	<b>change pcp</b>
Retail	4.6	17.0	269.4%	23.7	39.5%
Wholesale	4.6	2.4	-48.7%	2.8	18.6%
Segment EBT	9.2	19.4	110.4%	26.5	36.9%
Less: Corporate Costs	1.7	3.2		3.6	
Reported NPAT	7.5	16.2		22.9	
Add: Income Tax	3.1	8.0		9.8	
Group NPBT	10.5	24.2		32.7	

Source: Company data, Ord Minnett estimates

The segmental results were affected by some reclassifications of revenue (a Wholesale partner was reclassified) and accounting adjustments, most notably in the Wholesale division, which saw revenue grow by 71% while segment EBT fell 49% to \$2.4m. This result was also affected by price competition across the industry.

**Table 4: Wholesale Earnings Breakdown**

	<b>\$m</b>	<b>\$m</b>	<b>Comment</b>
FY09 EBT	4.6		
Accounting Changes	-1.8		Change in accounting policy that requires earnings to be booked over the life of contracts.
Allocation of Corporate Costs	-0.8		Corporate costs reallocated as part of the reclassification of revenue.
Organic Growth	0.4		OML estimate
FY10 EBT	2.4		

Source: Company data, Ord Minnett estimates

Retail revenue, which now houses Commander and People Telecom, grew by 124% while EBT grew by 269%. MTU has been able to achieve all stated integration goals and is improving the efficiency of both the acquired businesses.

Going forward, OM expects the Retail division to be the primary earnings driver, however MTU has maintained its commitment to continue servicing its Wholesale customers, who are mainly smaller ISPs and niche telecom resellers.

## Balance Sheet and Cashflow

The balance sheet was strengthened during the year by a \$20m capital raising by the issue of 11.1m shares at \$1.80 per share. Funds were used for general corporate purposes and to make 2 small acquisitions (selected assets of Clever Communications and Bell Networks).

These assets are expected to generate annualised EBT of ~\$4m in FY11 (OM estimate), contributing to the 40% growth in Retail segment EBT.

Gearing of 1.9% on a ND / ND +E basis is negligible, and EBIT interest cover of 11.8x is very strong, providing significant capacity to enable MTU to continue looking for suitable acquisitions. MTU have stated that they are still in the market to acquire if the right opportunity arises.

**Table 5: MTU Cashflow Conversion**

	FY06	FY07	FY08	FY09	FY10
EBITDA	3.7	4.1	9.1	13.3	31.4
Operating Cashflow	1.9	3.4	7.3	8.3	13.3
Add back tax paid	0.7	1.1	2.2	2.8	5.9
Add back net interest	-0.3	-0.2	0.6	1.4	2.5
OCF pre-int and pre-tax	2.3	4.3	10.0	12.6	21.7
Cashflow to Earnings	63.0%	105.8%	110.2%	94.3%	69.0%
Creditor Days	74.07	107.36	93.85	107.51	52.82
Debtor Days	72.94	62.51	71.22	90.22	50.11

Source: Company data, Ord Minnett estimates

Cashflow conversion was weaker than previous periods driven mainly by payment terms changing with major suppliers and with a large customer, with creditor days and debtor days falling markedly. The fall in creditor days equates to about \$6m of impact and the change in debtors days accounts for ~\$2m.

## Dividends

A final dividend of 5cps was declared by the board to go with the 5cps interim dividend. This equates to a payout ratio of 68.7% of Basic EPS. This is consistent with MTU's policy to pay out 70% of earnings in dividends.

We forecast dividends of 13cps in FY11 applying this same payout policy, which gives a prospective dividend yield of 6.6% fully franked.

## Outlook

MTU has provided earnings guidance for FY11 but made no qualitative statements regarding the outlook for the current year. Revenue is expected to increase by 5-9% to between \$425-\$445m, while EBITDA is expected to grow 30-36% to between \$41-\$42.5m.

## Changes to Estimates

**Table 6: MTU Estimate Changes FY11-FY12**

	FY11E Old	FY11E New	% variance	FY12E Old	FY12E New	% variance
Revenue (\$m)	429.5	425.8	-0.9%	454.2	447.8	-1.4%
EBITDA (\$m)	41.7	41.2	-1.1%	43.9	47.6	8.5%
EBIT (\$m)	35.4	35.2	-0.7%	37.4	39.5	5.5%
NPAT (\$m)	22.9	22.9	-0.1%	24.3	25.9	6.5%
EBITDA Margin	9.7%	9.7%		9.7%	10.6%	
Fully Diluted EPS (¢)	21.6	21.5	-0.7%	23.2	24.8	7.0%

Source: Company data, Ord Minnett estimates

Only minor changes have been made to our FY11 estimates and we sit at the midpoint of NPAT guidance going into 1H11. We are confident that efficiencies and recently announced acquisitions can drive NPAT growth of 40%+ on revenue growth of only 5-9%.

OM believes that EBITDA growth in FY11 can be achieved by a mix of organic growth, benefit from acquisitions as well as synergies derived from earlier acquisitions, given that in FY10 the benefits were largely offset by redundancy costs associated with rationalising call centres etc.

**Table 7: FY11 EBITDA Breakdown**

	\$m	\$m
FY10 EBITDA	31.4	
Organic Growth		4.1
Acquisitions (Clever Comm. and Bell Networks)		4.0
Synergies		1.7
FY11E EBITDA		41.2

Source: Company data, Ord Minnett estimates

## Recommendation and Valuation

We maintain our Accumulate recommendation and our valuation increases to \$2.35, due to our increasing confidence in the FY12 outlook and beyond.

Key reasons for our recommendation include:

- MTU owns valuable brands that are well recognised among the key target market of small and medium businesses.
- A sizeable on-the-ground sales force (400-500 people across the exclusive and dealer channels) meeting with potential customers provides a significant physical presence in the market.
- The business model requires very little capex and few fixed assets, making it capital efficient and cash generative.
- The addressable market is large, with Telstra still having a significant position (circa 80% market share). This is both an opportunity and a threat.
- Likely to be a beneficiary if an NBN is introduced.

Our DCF valuation is based on a WACC of 11.1%, beta of 1 and terminal growth rate of 2.5%.

## Risk Factors

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.

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.

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.

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

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## BUSINESS DESCRIPTION

Established in 1999, M2 Telecom is a network independent provider of retail fixed-line, mobile and data telecommunications services, specifically tailored towards Small to Medium Businesses (SMBs) in Australia and New Zealand.

The services are primarily sold via the Commander and People Telecom brands, utilising an on-the-ground sales force to deliver a high touch service to customers.

M2 Telecom also act as a wholesale supplier of telecommunications services to small internet service providers and other smaller resellers.

Please contact your Ord Minnett Adviser for further information on our document.

Research				
Stephen Scott	Head of Research	Sydney	sscott@ords.com.au	
John Lawlor	Senior Research Analyst	Brisbane	jlawlor@ords.com.au	
Peter Arden	Senior Research Analyst	Melbourne	parden@ords.com.au	
Richard Ivers	Senior Research Analyst	Melbourne	rivers@ords.com.au	
James Lennon	Senior Research Analyst	Sydney	jlennon@ords.com.au	
Brad Dunn	Analyst	Sydney	bdunn@ords.com.au	
David Sakti	Assistant Analyst	Melbourne	dsakti@ords.com.au	
James Xavier	Assistant Analyst	Sydney	jxavier@ords.com.au	
Nicholas McGarrigle	Research Associate	Sydney	nmcgarrigle@ords.com.au	
Corporate Finance				
Michael Hughes	Head of Corporate Finance	Sydney	mhughes@ords.com.au	
Michael Pash	Corporate Finance Director	Sydney	mpash@ords.com.au	
Trent Donnelly	Corporate Finance Director	Sydney	tdonnelly@ords.com.au	
Conrad Anderson	Associate Director	Sydney	canderson@ords.com.au	
Robert Stone	Corporate Finance Manager	Sydney	rstone@ords.com.au	

## Ord Minnett Branches

### Sydney (Head office)

Level 8  
NAB House  
255 George Street  
Sydney NSW 2000  
Tel: (02) 8216 6300  
Fax: (02) 8216 6311

### Bundall, Gold Coast

Level 5,  
140 Bundall Road  
Bundall QLD 4217  
Tel: (07) 5557 3333  
Fax: (07) 5574 0301

### Mackay

45 Gordon Street  
Mackay QLD 4740  
Tel: (07) 4969 4888

### Wollongong

3/55 Kembla Street  
Cnr Market and  
Kembla Streets  
Wollongong NSW 2520  
Tel: (02) 4226 1688  
Fax: (02) 4226 1604

### Adelaide

Level 11  
11-19 Grenfell Street  
Adelaide SA 5000  
Tel: (08) 8203 2500  
Fax: (08) 8203 2525

### Caloundra, Sunshine Coast

79-81 Bulcock Street  
Caloundra QLD 4551  
Tel: (07) 5491 3100  
Fax: (07) 5491 3222

### Melbourne

Level 23  
120 Collins Street  
Melbourne VIC 3000  
Tel: (03) 9608 4111  
Fax: (03) 9608 4142

### Brisbane

Level 10, Waterfront Place  
1 Eagle St  
Brisbane QLD 4000  
Tel: (07) 3214 5555  
Fax: (07) 3214 5550

### Canberra

101 Northbourne Avenue  
Canberra ACT 2600  
Tel: (02) 6206 1700  
Fax: (02) 6206 1720

### Newcastle

41-45 Newcomen Street  
Newcastle NSW 2300  
Tel: (02) 4910 2400  
Fax: (02) 4910 2424

### Buderim

Sunshine Coast  
84 Burnett Street  
Buderim QLD 4556  
Tel: (07) 5430 4444  
Fax: (07) 5430 4400

### Coffs Harbour

Suite 4  
21 Park Avenue  
Coffs Harbour NSW 2450  
Tel: (02) 6652 7900  
Fax: (02) 6652 5716

### Tamworth

Suite 3  
344-346 Peel Street  
Tamworth NSW 2340  
Tel: (02) 6761 3333  
Fax: (02) 6761 3104

Ord Minnett Limited  
ABN 86 002 733 048  
ASX Market Participant  
AFS Licence Number 237121

[www.ords.com.au](http://www.ords.com.au)

## 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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