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M2 Group looks to New Zealand and low-cost retail for growth

Chief executive Geoff Horth, pictured, runs M2 Group's operations, while founder Vaughan Bowen keeps an eye on mergers and acquisitions – a vital station at the telco. **James Alcock**

by **David Ramli**

As the $1.56 billion takeover of iiNet by TPG Telecom looks close to a done deal, investors have begun to question whether the underbidder M2 Group can continue to expand in a broadband market where it is a distant fourth behind Telstra, TPG and Singtel-Optus.

M2, the Melbourne-based phone and internet reseller that is best known for its subsidiary brands Dodo, iPrimus and Commander, has been a strong sharemarket performer. Its share price has risen almost 88 per cent over the past 12 months, giving it a market value of about $2 billion.

Analysts and investors laud its strong performance and excellent management, but after iiNet's board backed a bid by TPG over M2 it missed the opportunity to become Australia's second-largest internet service provider, which would have cemented its future in the market.

With TPG looking set now to take that prize, M2's expansion will probably come from acquisitions in adjacent markets – in a strategic and geographic sense.

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THE NEW ZEALAND PLAY

In April it paid $245 million for Auckland-based ISP CallPlus and 2Talk – businesses that, like M2, buy and resell phone and internet services from the incumbent players. The former is the third-biggest player in the New Zealand broadband market, with about 14 per cent.

Credit Suisse emerging companies analyst Bradley Clibborn is one of M2's strongest backers among the broker firms, with a 12-month price target of $13 a share. The stock closed at $11.26 on Friday.

He told clients earlier in July that recent draft regulatory decisions by New Zealand's Commerce Commission to slash the cost of renting copper phone lines would push the value of M2's acquisition even higher.

"M2 remains our key pick among the internet service providers," he said. "We believe M2's valuation looks compelling ... for a mid-teens earnings per share growth story with upside risks from organic growth, mergers and acquisitions and potential tailwinds from ACCC/NZ ComCom regulatory decisions."

But Morgan Stanley's Mark Goodridge is less convinced, with a 12-month price target of $10.40. He told clients when the deal was struck that New Zealand's broadband market was more mature and less attractive than Australia.

"In Australia the NBN will turn off consumers' connections if they have not moved across on the NBN in 18 months," he said. "This is not the case in New Zealand.

"Consequently, this reduces CallPlus' ability to take market share."

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Company Profile

Telecommunications supplier

www.m2.com.au

Diversified Telecommunication Services (501010)

ASIC 091575021

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CLOSER TO HOME

In Australia, M2 is also putting a lot of faith in its low-cost retail strategy. It will deploy about 100 Dodo kiosks across the nation's shopping centres by mid-2016, rather than go toe-to-toe against bigger players with hefty budgets.

To reduce costs even further these kiosks will be franchised out to business owners, who will take a cut of the sales they land for Dodo.

Citi analyst Ross Barrows described it as "a clever, unique strategy", while noting it would cost a business owner up to $100,000 a year for a kiosk on top of monthly expenses of $15,000.

"The break-even point for a franchisee is around 90 [broadband] services per month," he told clients. "Franchising aims to reduce capex, hasten the Dodo footprint expansion, grow sales and lower customer acquisition costs."

But the key to these kiosks will be the products they sell. Phone and internet services are the main staples, along with energy bundles for no-frill gas and electricity subscriptions.

Eventually M2 could offer more bundled products such as credit cards and other financial services, all of which would be placed on sale at purple kiosks near Kmarts and Woolworths outlets across suburbia.

MANAGEMENT

But ultimately it's M2's senior leadership team that has won over most analysts and investors. Chief executive Geoff Horth runs M2 Group's operations, while founder Vaughan Bowen keeps an eye on mergers and acquisitions – a vital station at the telco.

Cyan Investment Management director Dean Fergie said about 4 per cent of his fund was invested in M2. He said the team would steer the company to continued growth in 2015.

"As any company becomes larger it just becomes more and more difficult to continue to generate that growth," he said. "However, management has done a peerless job of integrating acquisitions and they seem to be continuing to find things to plug in.

He accepted that not all M2's ventures into financial services or overseas would succeed, and warned that any Telstra-style play further abroad than New Zealand would struggle to succeed.

But with TPG and iiNet potentially merging by August, Mr Fergie said a decline in competition was inevitable and could help M2 boost profitability.

He also thought the national broadband network would help M2 scoop up more clients, as Australians were forced to pick new internet providers.

"Two years ago, if you asked what my target price was I'd have said $7.50 per share," he said. "Now if I'm realistic it's probably worth $12.50 to $13 per share.

"But I wouldn't necessarily sell there – it's just the price where I wouldn't continue buying. If you still see a company increase value over time I don't think there's any particular reason to sell it."