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Melbourne IT (MLB)

Non-cash adjustments to forecasts

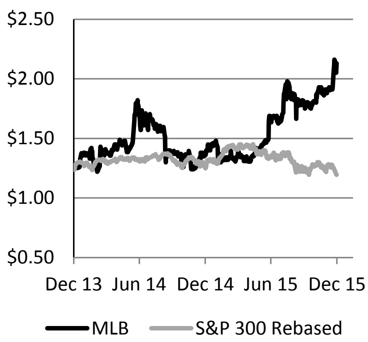
Recommendation
Buy (unchanged)
Price
$2.13
Target (12 months)
$2.40 (unchanged)

Expected Return	
Capital growth	12.7%
Dividend yield	2.8%
Total expected return	15.5%
Company Data & Ratios	
Enterprise value	$213.1m
Market cap	$198.0m
Issued capital	92.9m
Free float	79%
Avg. daily val. (52wk)	$228,485
12 month price range	$1.30 - $2.17
GICS sector	Software and Services

Price Performance

	(1m)	(3m)	(12m)
Price (A$)	1.86	1.80	1.35
Absolute (%)	14.52	18.33	57.78
Rel market (%)	17.83	21.76	64.13

Absolute Price



SOURCE: IRESS

Non-cash adjustments due to acquisition accounting rules

We have reviewed the acquisition accounting rules for the acquisition of the majority shareholding in Outware stake around mid year and, to be conservative, we have made two non-cash adjustments to our forecasts in each of the next three years:

- We have increased our forecast minority interest expense by c.$0.5m p.a. for the expensing of dividends to minority shareholders; and
- We have increased our forecast depreciation expense by between $0.6-0.7m p.a. for a greater level of acquired PPE than previously thought.

We note these are non-cash adjustments to our forecasts and our underlying forecasts are unchanged. We continue to forecast reported EBITDA in 2015 of $17.1m which is around the middle of the guidance range and still forecast underlying EPS in 2015 of 10.5cps which is also consistent with guidance.

Downgrades in reported EPS forecasts

These non-cash adjustments have led to downgrades in our reported EPS forecasts in 2015, 2016 and 2017 of 15%, 8% and 7% respectively. The downgrades are not insignificant but we stress they are due to non-cash adjustments arising from the acquisition accounting rules and our underlying forecasts are unchanged. Our view on the company and its outlook is therefore unchanged as well as the cash we forecast the business will generate in the future.

Investment view: Maintain BUY, PT $2.40

We maintain our BUY recommendation on Melbourne IT. We have updated each valuation we use in the determination of our price target for earnings changes as well as market movements and the time creep. We have also equated the percentage weightings of each valuation in the determination of the PT given the non-cash adjustments negatively impact the PE ratio valuation but do not impact the EV/EBITDA of DCF valuations. The net result is no change in our $2.40 price target.

Earnings Forecast

Year end 31 December	2014	2015e	2016e	2017e
Total revenue (A$m)	124.7	150.3	174.8	184.5
EBITDA (reported) (A$m)	12.8	17.1	28.8	32.7
NPAT after minority interest (A$m)	0.6	6.9	14.3	17.0
EPS (diluted) (cps)	0.7	5.8	12.0	15.9
EPS growth (%)	NM	NM	107%	32%
PER (x)	NM	36.6	17.7	13.4
Price/CF (x)	11.9	20.3	11.0	9.2
EV/EBITDA (x)	14.1	12.7	8.0	7.4
Dividend (¢ps)	5.0	5.0	6.0	7.0
Yield (%)	2.3%	2.3%	2.8%	3.3%
ROE (%)	0.6%	6.0%	11.8%	13.1%
Franking (%)	80.0%	80.0%	90.0%	100.0%

SOURCE: BELL POTTER SECURITIES ESTIMATES

Non-Cash Adjustments

Review of Acquisition Accounting Rules for Outware

We have reviewed the acquisition accounting rules for the acquisition of the majority shareholding in Outware stake around mid year (e.g. AASB 3 Business Combinations) and, to be conservative, we have made two non-cash adjustments to our forecasts in each of the next three years:

- We have increased our forecast minority interest expense by c.$0.5m p.a. for the expensing of dividends to minority shareholders; and
- We have increased our forecast depreciation expense by between $0.6-0.7m p.a. for a greater level of acquired PPE than previously thought.

The reason for the review is that, to date, Melbourne IT has only acquired a 50.2% stake in Outware and so, while it has a majority shareholding and consolidates the business, there are some differences in accounting for the acquisition compared to the full takeover of a company (e.g. the inclusion of dividend payments to minority shareholders in minority interest). Note Melbourne IT has put and call options in place to acquire up to 100% of Outware over the next two years (2016 and 2017) so the adjustments we have made to minority interest only apply in each of the next three years (2015-2017).

No Change in Underlying Forecasts

The adjustments we have made to our forecasts are non-cash and our underlying forecasts are unchanged. We continue to forecast reported EBITDA in 2015 of $17.1m which is around the middle of the guidance range and still forecast underlying EPS in 2015 of 10.5cps which is also consistent with guidance.

The calculation of our underlying EBITDA forecasts in 2H2015 and 2015 is shown in Figure 1 below. Note we only expect a modest level of adjustments in 2H2015 so the reported and underlying results in 2H2015 should not be dissimilar and the annualised 2H2015 result will provide the basis for 2016 before further anticipated cost synergies and expected organic growth in both the SMB and ES divisions.

Figure 1 - Calculation of underlying EBITDA forecast in 2015

Year end 31 December	1H2015	2H2015e	2015e
Reported EBITDA (A$m)	**5.2**	**11.9**	**17.1**
Adjustments:			
Transactions costs	1.7	0.3	2.0
Synergy costs	0.8	0.5	1.3
au.com provision	-0.8	-0.2	-1.0
Additional Outware contribution	2.4	0.0	2.4
Additional Uber contribution	0.7	0.0	0.7
Total adjustments	**4.8**	**0.5**	**5.3**
Underlying EBITDA	**10.0**	**12.4**	**22.4**

SOURCE: BELL POTTER SECURITIES ESTIMATES

Figure 1 shows we expect total adjustments in 2H2015 of around $0.5m which will take the total for 2015 up to just over $5m. This suggests that, based on our reported EBITDA forecast in 2015 of $17.1m, underlying EBITDA will be approximately $22.4m which is close to the top end of the $20.5-22.5m guidance range.

Earnings and Valuation Changes

Downgrades in Reported EPS Forecasts

The non-cash adjustments we have made have led to downgrades in our reported EPS forecasts in 2015, 2016 and 2017 of 15%, 8% and 7% respectively. The downgrades are not insignificant but we stress they are due to non-cash adjustments arising from our interpretation of the acquisition accounting rules and our underlying forecasts are unchanged. Our view on the company and its outlook is therefore unchanged as well as the cash we forecast the business will generate in the future.

A summary of the changes in our key forecasts is shown in Figure 2 below. Note there is no change in our revenue and EBITDA forecasts (i.e. no change in our underlying forecasts) and no change in our dividend forecasts (given the changes are non-cash).

Figure 2 - Change in key forecasts

Year end 31 December	2015e			2016e			2017e		
	Old	New	*Change*	Old	New	*Change*	Old	New	*Change*
Total revenue (A$m)	150.3	150.3	*0.0%*	174.8	174.8	*0.0%*	184.5	184.5	*0.0%*
EBITDA (reported)	17.1	17.1	*0.0%*	28.8	28.8	*0.0%*	32.7	32.7	*0.0%*
NPAT after min. interest	6.4	5.4	*-14.6%*	12.3	11.3	*-8.4%*	16.1	15.0	*-7.0%*
Diluted EPS (c)	6.8	5.8	*-14.6%*	13.1	12.0	*-8.4%*	17.1	15.9	*-7.0%*
DPS (c)	5.0	5.0	*0.0%*	6.0	6.0	*0.0%*	7.0	7.0	*0.0%*

SOURCE: BELL POTTER SECURITIES ESTIMATES

No Change in $2.40 Price Target

We have updated each valuation we use in the determination of our price target for earnings changes as well as market movements and the time creep. We have also equated the percentage weightings of each valuation in the determination of the PT given the non-cash adjustments negatively impact the PE ratio valuation but do not impact the EV/EBITDA of DCF valuations. The key assumptions we employ in each valuation of a 15% premium in the PE ratio and EV/EBITDA valuations and an 11.0% WACC and 3.0% terminal growth rate in the DCF valuation are unchanged.

The change in each valuation and the impact on the price target calculation is shown in Figure 3 below.

Figure 3 - Change in valuations and impact on price target

	Old (as at 4-Dec-15)			New (as at 16-Dec-15)		
	Valuation per share	% weighting	Price target	Valuation per share	% weighting	Price target
Methodology						
PE ratio	$2.20	40%	$0.88	$2.08	33%	$0.69
EV/EBITDA	$2.55	40%	$1.02	$2.61	33%	$0.87
DCF	$2.48	20%	$0.50	$2.51	33%	$0.84
Total			**$2.40**			**$2.40**

SOURCE: BELL POTTER SECURITIES ESTIMATES

Figure 2 shows there has been a 6% fall in the PE ratio valuation (due to the EPS downgrades) but a modest increase in both the EV/EBITDA and DCF valuation (due to market movements for the former and time creep for the latter). These movements combined with the change in percentage weightings, however, have resulted in no net change to our $2.40 price target.

Melbourne IT

Company Description

Melbourne IT is a leading provider of online services in Australia. The company has recently undergone a major transition where it sold two key businesses – DBS and FTR – and made three key acquisitions (NRG, Uber and a 50% stake in Outware). Key focus now is on providing managed digital solutions to small and medium enterprise customers.

The head office of Melbourne IT is in Melbourne, Victoria though, with the acquisition of NRG, the company now also has a major office in Sydney, New South Wales.

Investment Thesis

We retain our BUY recommendation on Melbourne IT. Our investment thesis is based on:

- **Valuation**: Our 12 month price target for Melbourne IT is $2.40. The price target is generated from a blend of three valuation methodologies: PE ratio, EV/EBITDA and DCF. The price target is a 13% premium to the current share price and the total expected return (including the forecast 2016 dividend yield) is 16%.
- **Leading player**: Melbourne IT is one of the leading online services providers in Australia and, with the acquisitions of NRG and Uber, is also one of the largest. The company has an established customer base, a range of products and services, an established track record and proven management.
- **Forecast strong growth**: We forecast strong earnings growth for Melbourne IT over the medium term coming from a mix of both organic growth and acquisitions. Over the next three years (2015 to 2017) we forecast statutory or reported EPS to grow from 5.8cps to 15.9cps (which equates to a CAGR of 65%) and underlying EPS to grow from 8.0cps to 17.5cps (which equates to a CAGR of 48%).

Key Risks

Key downside risks to our estimates and valuation include (but are not limited to):

- **Competition**: The online services market in Australia is competitive and comprises a large number of domestic and international players. Competition tends to be price driven (due to lack of product differentiation) and discounting is common. A greater level of competition or discounting than we have assumed could result in downside risk to our forecasts.
- **Acquisition/cost synergies**: Melbourne IT has made a number of recent acquisitions and a large part of the company's forecast earnings growth over the short to medium term is being driven by both the earnings from these acquisitions and the cost synergies from combining the businesses. A risk is that the acquisitions do not perform as expected and/or the cost synergies are not as great as expected.
- **Goodwill**: Melbourne IT has relatively large goodwill on its Balance Sheet which has mostly come through acquisitions. This goodwill will be subject to regular impairment tests and whether it passes those tests or not will largely depend on the performance of the acquisitions. The total equity of Melbourne IT is only around $115m so any write down of goodwill would have likely have a material impact on the equity of the company.

Melbourne IT
as at 16 December 2015

Recommendation	Buy
Price	$2.13
Target (12 months)	$2.40

Table 1 - Financial summary

Melbourne IT (MLB)

Share price:	**$2.13**	**Target price:**	**$2.40**
No. of issued shares:	**92.9m**	**Market cap:**	**$198.0m**

Profit & Loss (A$m)

Year end 31 Dec	2013	2014	2015e	2016e	2017e
Total revenue	**103.4**	**124.7**	**150.3**	**174.8**	**184.5**
Change	*-5%*	*21%*	*21%*	*16%*	*6%*
EBITDA	**5.8**	**12.8**	**17.1**	**28.8**	**32.7**
Depreciation	-2.0	-2.4	-3.7	-4.0	-4.3
Amortisation	-0.8	-1.9	-2.1	-2.2	-2.2
Impairment	0.0	-8.6	0.0	0.0	0.0
EBIT	**3.0**	**-0.1**	**11.3**	**22.7**	**26.2**
Net interest revenue/(expense)	2.5	0.4	-1.4	-2.8	-2.1
Costs recovered from discont.	0.3	0.0	0.0	0.0	0.0
Pre-tax profit	**5.9**	**0.3**	**9.9**	**19.8**	**24.1**
Income tax benefit/(expense)	0.3	0.4	-3.0	-5.5	-7.1
NPAT before min. interest	**6.2**	**0.6**	**6.9**	**14.3**	**17.0**
Discont. Ops / Min. Interest	62.7	0.0	-1.5	-3.0	-2.0
NPAT after minority interest	**68.9**	**0.6**	**5.4**	**11.3**	**15.0**

Cash Flow (A$m)

Year end 31 Dec	2013	2014	2015e	2016e	2017e
EBITDA	5.8	12.8	17.1	28.8	32.7
Change in working capital	1.1	-0.8	-2.9	-2.4	-1.8
Gross operating cash flow	**6.9**	**12.0**	**14.2**	**26.5**	**31.0**
Interest received	2.6	0.6	0.2	0.2	0.3
Interest paid	-0.2	-0.2	-1.6	-3.1	-2.4
Bank charges	-0.8	-1.2	0.0	0.0	0.0
Tax paid	-1.2	4.8	-3.0	-5.5	-7.1
Operating cash flow	**7.3**	**16.1**	**9.8**	**18.1**	**21.7**
Payments for PPE	-1.8	-6.3	-4.0	-4.3	-4.5
Payments for trans. assets	-3.7	0.0	0.0	0.0	0.0
Payments for acquisitions	0.0	-41.0	-37.0	-22.7	-22.7
Proceeds from sale of	121.9	15.3	0.0	0.0	0.0
Proceeds from sale of PPE	0.3	0.0	0.0	0.0	0.0
Net payment of deposits	0.0	0.0	0.0	0.0	0.0
Investing cash flow	**116.7**	**-32.0**	**-41.0**	**-26.9**	**-27.2**
Proceeds from borrowings	0.0	20.0	30.0	20.0	20.0
Repayment of borrowings	-34.6	-20.0	0.0	0.0	-10.0
Proceeds from shares	0.1	0.0	0.0	0.0	0.0
Capital return	0.0	-45.2	0.0	0.0	0.0
Dividends paid	-26.4	-1.2	-4.7	-5.6	-6.1
Financing cash flows	**-61.0**	**-46.5**	**25.3**	**14.4**	**3.9**
Net change in cash	**62.9**	**-62.4**	**-5.9**	**5.6**	**-1.5**
Forex differences	-0.3	0.0	0.0	0.0	0.0
Cash at start of period	17.9	80.5	18.1	12.2	17.8
Cash at end of period	**80.5**	**18.1**	**12.2**	**17.8**	**16.2**

Balance Sheet (A$m)

Year end 31 Dec	2013	2014	2015e	2016e	2017e
Cash	80.5	18.1	12.2	17.8	16.2
Receivables	24.2	8.7	11.3	13.1	13.8
Inventories	0.0	0.0	0.0	0.0	0.0
Prepayments	6.3	10.0	10.0	10.0	10.0
Other current assets	7.0	2.6	2.6	2.6	2.6
PPE	3.0	4.9	5.2	5.5	5.6
Investments	0.0	0.0	0.0	0.0	0.0
Intangibles - Goodwill	52.3	100.0	135.1	156.7	178.2
Intangibles - Other	17.0	18.9	18.7	17.7	16.6
Deferred tax assets	3.3	4.5	4.5	4.5	4.5
Other non-current assets	5.3	6.4	6.4	6.4	6.4
Total assets	**198.8**	**174.1**	**206.1**	**234.2**	**254.1**
Payables	17.4	13.8	15.0	17.5	18.4
Current borrowings	0.0	0.5	0.5	0.5	0.5
Current provisions	3.0	4.1	4.1	4.1	4.1
Deferred revenue	16.7	26.2	26.2	26.2	26.2
Non-current borrowings	0.0	0.0	30.0	50.0	60.0
Non-current provisions	1.2	1.3	1.3	1.3	1.3
Non-current deferred revenue	12.4	13.5	13.5	13.5	13.5
Other non-current liabilities	0.0	0.0	0.0	0.0	0.0
Total liabilities	**50.8**	**59.3**	**90.6**	**113.0**	**124.0**
Contributed equity	68.8	35.6	35.6	35.6	35.6
Reserves	4.5	4.7	4.7	4.7	4.7
Retained earnings/(losses)	74.8	74.4	75.1	80.8	89.7
Total shareholders' equity	**148.1**	**114.8**	**115.5**	**121.2**	**130.1**

Valuation data

Year end 31 Dec	2013	2014	2015e	2016e	2017e
NPAT after min. interest (A$m)	6.2	0.6	6.9	14.3	17.0
Diluted EPS (c)	7.4	0.7	5.8	12.0	15.9
Change	*-29%*	*NM*	*NM*	*107%*	*32%*
P/E ratio (x)	**28.7**	**NM**	**36.6**	**17.7**	**13.4**
CFPS (c)	8.8	17.9	10.5	19.3	23.1
Price/CF (x)	**24.3**	**11.9**	**20.3**	**11.0**	**9.2**
DPS (c)	25.0	5.0	5.0	6.0	7.0
Yield	**11.7%**	**2.3%**	**2.3%**	**2.8%**	**3.3%**
Franking	75%	80%	80%	90%	100%
EV/EBITDA (x)	**20.2**	**14.1**	**12.7**	**8.0**	**7.4**
EV/EBIT (x)	38.7	-1555.2	19.1	10.2	9.2
NTA per share (c)	94.3	-4.6	-41.1	-56.7	-68.8
Price/NTA (x)	**2.3**	**-46.6**	**-5.2**	**-3.8**	**-3.1**

Performance ratios

Year end 31 Dec	2013	2014	2015e	2016e	2017e
EBITDA margin	**5.8%**	**10.3%**	**11.4%**	**16.5%**	**17.8%**
EBIT margin	3.0%	-0.1%	7.6%	13.0%	14.2%
Return on assets	3.1%	0.4%	3.4%	6.1%	6.7%
Return on equity	**4.2%**	**0.6%**	**6.0%**	**11.8%**	**13.1%**
ROIC	NM	NM	9.8%	15.7%	16.0%
Payout ratio	337%	695%	86%	50%	44%
Effective tax rate	6%	123%	-30%	-28%	-30%

Leverage ratios

Year end 31 Dec	2013	2014	2015e	2016e	2017e
Net debt/(cash) (A$m)	-80.5	-17.6	18.3	32.7	44.3
Net debt/equity	**-54%**	**-15%**	**16%**	**27%**	**34%**
Gearing	-119%	-18%	14%	21%	25%
Net debt/EBITDA (x)	-13.8	-1.4	1.1	1.1	1.4
Net interest cover (x)	-1.2	0.3	8.0	8.0	12.3

Segmentals (A$m)

Year end 31 Dec	2013	2014	2015e	2016e	2017e
Revenue					
SMB Solutions					
Registration	44.8	53.3	61.2	65.2	66.2
Hosting & value-added products	31.3	42.4	49.9	54.9	58.4
Other revenue	0.2	0.5	0.4	0.5	0.6
SMB revenue	**76.3**	**96.3**	**111.5**	**120.6**	**125.1**
ES					
Hosting & value-added products	24.4	27.8	38.6	54.0	59.1
Other revenue	0.0	0.0	0.0	0.0	0.0
ES revenue	**24.4**	**27.8**	**38.6**	**54.0**	**59.1**
SMB Solutions + ES					
Registration	44.8	53.3	61.2	65.2	66.2
Hosting & value-added products	55.7	70.3	88.4	108.8	117.5
Other revenue	0.2	0.5	0.4	0.5	0.6
Segment revenue	**100.7**	**124.1**	**150.1**	**174.5**	**184.2**
EBITDA					
SMB Solutions	8.9	13.6	16.1	22.0	24.4
ES	2.4	4.4	7.7	13.0	14.8
EBITDA before unallocated	**11.3**	**18.0**	**23.8**	**35.0**	**39.2**
Unallocated corporate expense	-4.9	-5.2	-6.8	-6.1	-6.4
Transformation projects	-0.5	0.0	0.0	0.0	0.0
EBITDA after unallocated exp.	**5.8**	**12.8**	**17.1**	**28.8**	**32.7**

Interims

Year end 31 Dec	1H2014	2H2014	1H2015	2H2015e
Total revenue (A$m)	**59.2**	**64.9**	**69.0**	**81.1**
Change	*18%*	*29%*	*16%*	*25%*
EBITDA (A$m)	**3.6**	**9.2**	**5.2**	**11.9**
EBITDA margin	*6.1%*	*14.1%*	*7.5%*	*14.7%*
NPAT from cont. ops. (A$m)	-4.6	5.2	1.4	5.5
Diluted EPS (c)	**-5.2**	**6.0**	**1.3**	**4.6**
DPS (c)	1.0	4.0	1.0	4.0

SOURCE: BELL POTTER SECURITIES ESTIMATES

Recommendation structure

Buy: Expect >15% total return on a 12 month view. For stocks regarded as 'Speculative' a return of >30% is expected.

Hold: Expect total return between -5% and 15% on a 12 month view

Sell: Expect <-5% total return on a 12 month view

Speculative Investments are either start-up enterprises with nil or only prospective operations or recently commenced operations with only forecast cash flows, or companies that have commenced operations or have been in operation for some time but have only forecast cash flows and/or a stressed balance sheet.

Such investments may carry an exceptionally high level of capital risk and volatility of returns.

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