new|street RESEARCH

Spirit Telecom (ASX: ST1)

Proving the model

What's New: Spirit's quarterly activity report showed a 12% increase in customer receipts over the December quarter. It has nearly doubled its run rate in buildings connected and achieved strong customer growth without overly stretching its growth opex although capex has lifted somewhat to A$545k (from $475k in Dec qtr). These well-managed operational gains have allowed Spirit to increase operating cashflow (pre-capex) by 90% to over A$100k.

Changes to estimates/ guidance: We have revised our FY17F lifting revenue slightly and EBITDA margin to 12.0% from 6.4%. Although our opex and capex forecasts have increased with a higher growth outlook, the key effect is to lift medium term cash forecasts as quicker growth delivers quicker returns. We expect Spirit may accelerate growth further in FY18F.

Changes to thesis: No change to thesis. The growth rate is somewhat stronger which we expect will deliver a quicker lift in revenue with impact on EBITDA margin mitigated in the near term by costs of growth. The limit to the growth rate it might achieve may be a function of the source or cost of funding for capex.

Valuation: Our DCF valuation has lifted to A$45.1m from A$39.7m. We revised our 12m target price to AU 24.0c post dilution (25.5cps pre-dilution). The key catalyst is an ongoing demonstration of growth in connections and subscribers, with good resource control, in turn driving strong growth in operating cashflow. On this basis we retain our Buy recommendation on Spirit.

Buy

Ticker:	ST1 AU Equity
Target price, A$:	0.24
Potential Change:	55%

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	1m	3m	12m
Performance	0.0%	-8.8%	34.8%
52wk high/low	0.2	0.1	
Market cap. ($bn)		0.1	
No. Shares:		184	
Avg daily trading volume ($m):		0.03	
Free Float %:		47.2%	

Valuation Summary

Forecasts, A$m	2017E	2018E	2019E
Revenue	13	17	20
EBITDA	2	2	4
EFCF/Share	-0.01	0.00	0.00
DPS	0.00	0.00	0.01
Multiples			
EV/EBITDA	20.8x	14.6x	8.0x
EV/FCF	-49.6x	255.5x	29.5x
P/E	50.7x	32.5x	15.3x
Div Yield	0.0%	0.0%	3.2%

Source: New Street Research estimates

Table 1: Spirit Telecom Operating Performance (A$m)

	FY15A	FY16A	FY17F	FY18F	FY19F	3 Year CAGR
Sales Revenue	6.14	8.85	12.65	16.71	19.61	30.4%
EBITDA	0.19	0.02	1.52	2.18	3.84	n.a.
EBITDA margin (%)	3.1%	0.2%	12.0%	13.1%	19.6%	
EBIT	(0.04)	(0.56)	0.88	1.38	2.78	n.a.
NPAT Attributable	(0.16)	(2.14)	0.56	0.88	1.87	n.a.
EPS (cps)	(66.83)	0.20	0.31	0.48	1.01	n.a.
DPS (cps)	0.00	0.00	0.00	0.00	0.50	

Note: Spirit completed a 1:5 share consolidation on 16 March 2017. We have adjusted prior year EPS in line with the consolidation

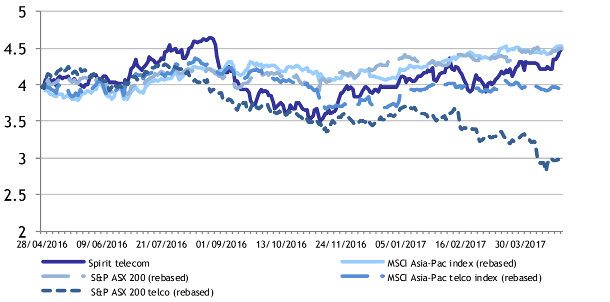
Source: New Street Research estimates, new|street RESEARCH

Spirit Telecom (ASX: ST1)

Target: AU 24.0cps (+/-55%)

EV CALCULATION (A$m)	2017E	2018E	2019E	2020E	CAGR 17E-20E
Share price, A$	0.16				
Number of shares	184	184	184	184	
Market cap.	28.5	28.5	28.5	28.5	
Plus: Net debt (Cash)	3.1	3.4	3.0	1.7	
Plus: Other financial liabilities	0.0	0.0	0.0	0.0	
Less: Associates	0.0	0.0	0.0	0.0	
Plus: Minorities	0.0	0.0	0.0	0.0	
Less: Cumulative dividends	0.0	0.0	0.9	2.8	
Less: NPV YE tax credit	0.0	0.0	0.0	0.0	
Enterprise Value	31.6	31.9	30.6	27.5	-4.6%

PRICE PERFORMANCE, -1Y



MULTIPLES & RATIOS	2017E	2018E	2019E	2020E	CAGR 17E-20E
EV/Revenue	2.5	1.9	1.6	1.2	21.2%
EV/EBITDA	20.8	14.6	8.0	4.5	58.7%
EV/OpFCF	(34.7)	178.8	20.6	5.6	(275.8%)
EV/FCF	(49.6)	255.5	29.5	7.9	(275.8%)
EV/Invested capital	3.4	3.0	2.6	2.3	(12.5%)
EV/NFA	8.1	6.2	4.7	4.4	(18.6%)
P/EFCF	(24.2)	(320.4)	55.7	8.7	(240.7%)
Adjusted P/E	50.7	32.5	15.3	8.8	79.3%
Dividend yield	0.0%	0.0%	3.2%	6.5%	nm
EFCF yield	(4.1%)	(0.3%)	1.8%	11.5%	(240.7%)
Net debt/EBITDA	2.0	1.5	0.8	0.3	(48.1%)
OpFCF/Net interest	6.9	(1.1)	(9.6)	(43.0)	(284.1%)

FINANCIALS (A$m)	2016A	2017E	2018E	2019E	2020E	CAGR 17E-20E
Revenue	8.8	12.7	16.7	19.6	22.5	21.2%
EBITDA	0.0	1.5	2.2	3.8	6.1	58.7%
Capex	0.9	2.4	2.0	2.4	1.1	(22.7%)
OpFCF (EBITDA - capex)	(0.9)	(0.9)	0.2	1.5	4.9	(275.8%)
FCF (OpFCF * (1-tax rate))	(0.6)	(0.6)	0.1	1.0	3.5	(275.8%)
EFCF	(0.9)	(1.2)	(0.1)	0.5	3.3	(240.7%)
Adj net Income	0.0	0.6	0.9	1.9	3.2	79.3%
Clean EPS (cps)	0.2	0.3	0.5	1.0	1.8	79.3%
DPS (cps)	0.0	0.0	0.0	0.5	1.0	nm
Cash flow						
OpFCF	(0.9)	(0.9)	0.2	1.5	4.9	
Less: Interest	(0.1)	(0.1)	(0.2)	(0.2)	(0.1)	
Less: Tax	0.0	(0.2)	(0.3)	(0.8)	(1.4)	
Less: Change in WC	0.5	0.1	0.2	(0.1)	(0.2)	
Less: Restructuring payments	0.0	0.0	0.0	0.0	0.0	
Less: Other	(0.3)	(1.2)	(0.6)	(0.8)	(0.1)	
Sub total	(0.8)	(2.4)	(0.7)	(0.3)	3.2	
Plus: Disposals/acquisitions/other	0.0	(4.2)	(0.2)	(0.2)	(0.2)	
Less: Dividends	0.0	0.0	0.0	0.0	(1.8)	
Less: Share buyback/Issue	2.5	2.3	0.0	0.0	0.0	
Less: Other	0.0	1.2	0.6	0.8	0.1	
Chg in Net debt/Cash	1.6	(3.2)	(0.2)	0.3	1.3	
Net debt (Cash)	(0.0)	3.1	3.4	3.0	1.7	

DIVISIONAL (A$m)	2016A	2017E	2018E	2019E	2020E	CAGR 17E-20E
Telco Revenue	8.8	11.9	15.2	18.1	20.9	20.6%
PNM Revenue	0.0	0.7	1.5	1.5	1.6	30.2%
Total Sales Revenue	8.8	12.7	16.7	19.6	22.5	21.2%

SELECTED BOND DATA

Moody's	Outlook	S&P	Outlook

Issue size (mn)	Price	OAS

Yld to maturity	Yld to worst

OAS HISTORY

No publicly traded bonds

*Source: Bloomberg, NSR; OAS-Option Adjusted Spread; *+/ *- credit rating watchlists; Data as of 07/02/2017*

DEFINITIONS: OpFCF = EBITDA - capex; FCF = OpFCF * (1 - tax rate); EFCF = Clean net income + depreciation - capex. EFCF yield adjusts mkt cap. for the NPV of tax credits & all other one-off cash items.

Proving the model

Spirit's 3Q17 Activities Report shows strong progress in building on-net gains in 3Q, and sets the company up well for delivering FY17 results ahead of our previous forecasts. We consider Spirit is now well positioned through 2H17 to prove its business model, that is that it can secure steady growth in building connections and customer activations, build revenue and control resources well enough to both build on-net margin and contribute further operating cashflow to support growth.

Spirit increased cash receipts by 12.8% (over 2Q17) to A$3.36m, ahead of our 2H17F run rate. It added 58 buildings connected (including residential and commercial) in 3Q17 nearly doubling its monthly run rate from 10.3pm in 1H17 to 18.7pm in 3Q17. Spirit now has 306 buildings connected and we have increased our forecast of buildings connected at 30 June 2017 to 361.

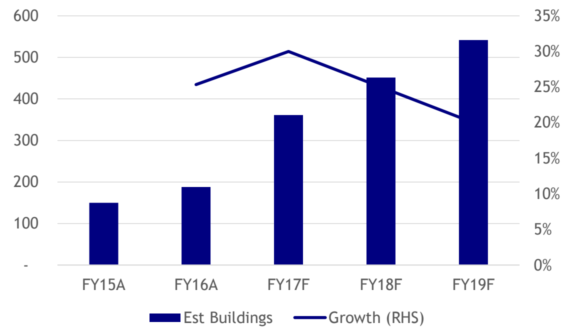
Table 2: Spirit Profit and Loss Summary (A$m)

	FY15A	FY16A	FY17F	FY18F	FY19F
Telco Revenue	6.1	8.8	11.9	15.2	18.1
PNM Revenue			0.7	1.5	1.5
Sales revenue	6.1	8.8	12.7	16.7	19.6
Cost of Sales	3.3	4.1	5.0	6.6	7.5
Gross Profit	2.9	4.71	7.7	10.1	12.2
Gross Margin	46.7%	53.2%	60.6%	60.5%	62.0%
Other operating expenses	2.7	4.7	6.2	7.9	8.3
Underlying EBITDA	0.19	0.02	1.52	2.18	3.84
EBITDA Margin (%)	3.1%	0.2%	12.0%	13.1%	19.6%
Total D&A	0.23	0.58	0.64	0.81	1.05
EBIT	(0.04)	(0.56)	0.88	1.38	2.78
Net Finance Costs	(0.08)	(0.14)	(0.13)	(0.16)	(0.15)
Income Tax Expense	(0.04)	0.71	(0.19)	(0.34)	(0.76)
NPAT underlying	(0.16)	0.01	0.56	0.88	1.87
Exceptionals	-	(2.16)	-	-	-
Reported NPAT	(0.16)	(2.14)	0.56	0.88	1.87
Underlying EPS (cps)	(66.8)	0.20	0.31	0.48	1.01

Note: Spirit completed a 1:5 share consolidation on 16 March 2017. We have adjusted prior year EPS in line with the consolidation Source: New Street Research estimates

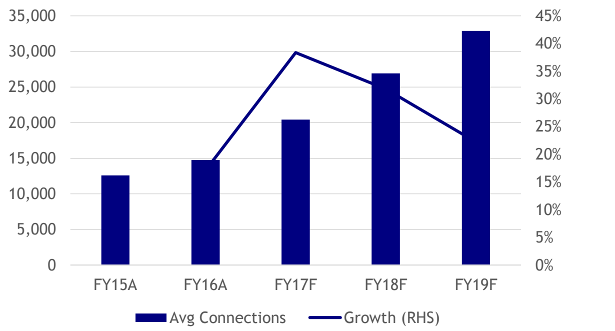
Spirit also focussed its efforts in increasing on-net customer connections. Residential and student activations increased 9% over the quarter to 3,907. Student customer numbers are falling as Spirit deals directly with premises bodies in a B2B model than directly with students. Spirit also added apartments in the Eureka Tower and since activation of service in February has gained 20% of residents.

Chart 1: KPIs - Buildings



Source: New Street Research estimates

Chart 2: KPIs - Connections



Source: New Street Research estimates

Despite faster growth in connections and activations Spirit has controlled resources well to achieve a 90% increase in operating cashflow (pre capex) to A$101k in the quarter. This has lifted cash conversion from 1.8% in the Dec qtr to 3.0%. Capex per building fell from A$11,900 Dec YTD to A$9,400, partly reflecting the increase in connections to smaller buildings.

Adjustments to forecasts

We have increased our FY17F telecoms revenue forecast from A$12.3m to A$12.7m with room, with risk more likely to the upside as the company moves through 4Q17. We have also adjusted upwards following year revenue forecasts and in the context of accelerated connections and activations growth, we again consider risk is more likely to the upside.

Table 3: Revisions to our forecasts for Spirit

	FY16A	FY17F	FY18F	FY19F
Previous				
Buildings connected YE	200	260	325	390
Capex (A$m)	0.87	1.21	1.39	1.53
Revenue (A$m)	8.85	12.32	15.45	17.97
EBITDA (A$m)	0.02	0.79	1.54	2.95
Margin	0.2%	6.4%	10.0%	16.4%
Revised				
Buildings connected YE	188	361	451	542
Capex (A$m)	0.87	2.43	2.00	2.35
Revenue (A$m)	8.85	12.65	16.71	19.61
EBITDA (A$m)	0.02	1.52	2.18	3.84
Margin	0.2%	12.0%	13.1%	19.6%

Source: New Street Research estimates

The pleasing aspect of the 3Q result is the good control of resources as growth lifted. We think this bodes well for both our FY17F gross margin of 60.6% and EBITDA. We have increased our FY17F EBITDA from A$0.8m (6.4% margin) to A$1.52m (12.0% margin).

Bear in mind costs may increase further with accelerated growth. It may well pay Spirit to increase its direct marketing spend from c$25-30k per month as it lifts its connections rate in order to drive better activation rates. Indeed the activation rate fell slightly in 3Q17 as connections outpaced activations. As it grows quickly it is also increase headcount and premises space.

With the good cash operating performance Spirit reduced its debt by A$210k from its principle Bank debt facility. It retains cash of A$1.07m after funding capex of A$545k in the quarter, sufficient to fund A$615k indicated for 4Q17.

Share consolidation

Spirit consolidated its share base on a one for five (1:5) basis in March taking total shares from 920.25m to 184.05m. Options and rights total 49.72m (previously 248.6m.) Options are out of the money at present but in the money on our valuation (see below).

Table 4: 2017 Share Consolidation

	Pre Consolidation Securities (m)	Post Consolidation Securities (m)	Pre Consolidation Option Exercise Price	Post Consolidation Option Exercise Price
ST1 Fully Paid Ordinary Shares	920.25	184.05	N/A	N/A
ST1O Listed options expiring 31 July 2019	223.27	44.65	$0.039	$0.197
ST1AC Unlisted options expiring 24 Nov 2019	12.50	2.50	$0.038	$0.190
ST1AB Performance Rights	12.85	2.57	N/A	N/A

Source: New Street Research estimates, ST1 ASX release March 2017

Regulatory risk has eased

In our initiation report ('Spirit is Willing', 2 February 2017) we noted our concern that a proposed $7 NBN levy on rival fixed broadband carriers to the NBN could materially damage the company. It remains uncertain whether the levy would apply to Spirit given it mostly has fixed wireless access. In any case the industry regulator, the Australian Competition and Consumer Commission (ACCC) has relented on its initial proposal that impacted carriers would not be allowed to pass the charge onto customers but would have to absorb the cost in a margin squeeze. It now considers that affected carriers would be allowed to pass on charges in any regulated price setting.

It also remains unclear whether Spirit, as a predominantly fixed wireless access provider of broadband service, would (i) be required to pay the levy, (ii) be required by forthcoming regulation to structurally separate, and (iii) be included in the ACCC's declaration of rival HS broadband access providers (which would require Spirit to offer a wholesale service to other RSPs and allow the ACCC to regulate such wholesale access service prices). Initially the ACCC exempted fixed wireless operators from the declaration but noted in January that it may reconsider this exemption.

Revisions to valuation and target price

With revisions to operating forecasts we now value Spirit at A$45.1m (prev A$39.7m) on a DCF basis, an equity valuation of A$42.6m (prev A$37.2m) after net debt of A$2.5m. This is AU 23.2cps against shares on issue of 184.1m. Options and performance rights are exercisable at AU 19.7cps and 19.0cps, which would dilute our equity valuation to AU 22.2cps if exercised.

We revised our 12m target price to 24.0c post dilution (25.5cps pre-dilution) given the TP is above the exercise price. [Our previous TP of AU 4.6cps post dilution (4.8cps pre-dilution) equates to post consolidation prices of 23.0cps (24.0cps)]. On this basis we retain our Buy recommendation on Spirit.

Our target price is based on Spirit demonstrating a certain revenue growth rate with notional or normalised EBITDA growth over 12m. Spirit currently trades around 20x FY17F EBITDA of A$1.5m. We consider the market price really reflects an underlying or notional EBITDA after adjusting for costs of growth, i.e. a sustainable moderate growth EBITDA once it has achieved a steady operating result.

To guide our target price we construct a notional EBITDA based on EBITDA margins ex cost of growth. We think market price in 12 months will reflect the extent to which Spirit demonstrates its ability to achieve a post growth EBITDA margin in the mid 30% range beyond FY20F. On this basis we consider Spirit currently trades on 9.8x notional FY17F EBITDA of A$3.2m ex costs of growth (ie a 25% margin on FY17F revenue of A$12.7m). If it can continue to demonstrate growth in the year ahead, we expect its share price will reflect 9.8x a notional FY18F EBITDA of A$5.0m ex costs of growth (ie a 30% margin on FY18F revenue of A$16.7m).

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Rating history

Ratings	% Buy	%Neutral	% Sell
% last 12 months ST1	100.0%	0.0%	0.0%
% all stocks undercover	53.5%	36.9%	9.6%

Full 12-month historical recommendation changes are available on request

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