Woodward Research

22 November 2011

Trade Me

Iconic success story Trade Me has grown into a mature company with strong cash flows and impressive profitability well able to support an attractive dividend

Valuation

Woodward Research compared three valuation approaches - discounted cash flow (**DCF**) analysis, comparable company analysis, and dividend yield analysis – to arrive at a valuation for Trade Me (NZX:TME) of **$2.54 per share**. This equates to a market capitalisation of $1,007 million. Trade Me is forecast to have net debt of $166 million immediately following the IPO, implying an enterprise value of $1,173 million.

Target Price

Our 12-month target price for Trade Me is $2.80 per share.

Key Points

- Trade Me is the dominant player in all but one of its business lines.
- The company has a board and management team with proven track records at Trade Me.
- Trade Me's revenue growth rate is slowing and its margins are declining.
- But Trade Me still has the highest EBITDA margin of all NZSX-listed companies.
- Given the IPO pricing ($2.70 per share) and the tapering revenue growth we expect that most of the returns to shareholders going forward are likely to come in the form of dividends rather than capital appreciation.
- As a yield-oriented stock, Trade Me will be sensitive to rising interest rates.

Opinion

We believe Trade Me will earn its investors a modest but predictable return driven mostly by its dividend. As a name that New Zealanders trust, the company has now reached its mature growth phase, with predictable revenues and strong cash flows that can support a healthy dividend. As such, we believe Trade Me is an investment that should be considered more for its yield than its potential growth.

Company Background

Founded in 1999, Trade Me has grown to become the dominant online auction and classifieds business in New Zealand. The site's 2.8 million registered members use Trade Me to buy and sell new and used goods for their homes and businesses. Trade Me also offers classified advertisements for automobiles, property, and jobs, as well as a dating site (FindSomeone) and a group buying coupon site (TreatMe).

Valuation Summary

Enterprise valuation	$ 1,173 million
Net debt	-$ 166 million
Market capitalisation	$ 1,007 million
Equity value per share	$ 2.54 per share

Year to 30 June		11A	12E	13E	14E
Revenue	($m)	128.8	144.8	159.0	166.0
EBITDA	($m)	98.1	104.9	113.2	118.0
NPAT	($m)	69.8	68.8	70.2	73.4
EV/EBITDA	(x)	11.8	11.0	10.2	
EV/EBIT	(x)	12.2	11.6	10.8	
P/E	(x)	15.5	15.5	15.2	
EPS	($)	0.17	0.17	0.18	0.19
DPS	($)	0.00	0.10	0.14	0.15
Dividend yield	(%)	0.0	3.8	5.3	5.5

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Overview Of The Business

Entrepreneur Sam Morgan launched the Trade Me website in 1999. From there the company has grown to become the leading and dominant online marketplace and classifieds business in New Zealand.

Today, Trade Me has 2.8 million registered members who use the website to buy and sell new and used goods for their homes and businesses. The site also offers classified advertisements for automobiles, property, and jobs, as well as a dating site (FindSomeone), and a new group buying coupon site (TreatMe).

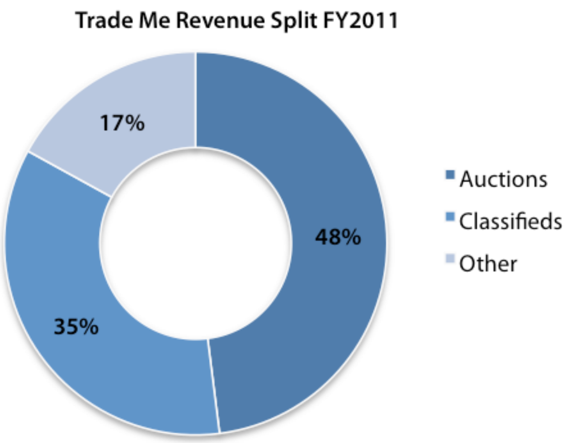
In 2006, Fairfax Media (**Fairfax**) (ASX:FXJ) acquired Trade Me for $700 million, plus an earn-out of up to an additional $50 million, which was fully earned following the acquisition.

Trade Me has continued to grow under Fairfax's ownership and today dominates nearly all of the business lines it operates in. The company continues to launch new services, including most recently Treat Me.

In the 12 months ending 30 June 2011 Trade Me had revenues of $128.8 million, pro-forma EBITDA of $97.0 million, and pro-forma EBIT of 93.5 million. As at the completion of the offer, Trade Me is expected to have total assets of $768.7 million.

Business Portfolio

Trade Me's primary businesses include auctions (48% of revenues), classifieds (35%) and other revenues, which are mainly display advertising and revenues from Trade Me's other website properties.



Source: IPO Prospectus

Auctions

In order to encourage users to list items for sale Trade Me does not charge a listing fee for most items (with a few specialised exceptions). The primary revenue driver for auctions is collecting success fees on auctions that close, representing 65% of the revenues in this category. Other revenues are derived from promotional fees (26% of revenues), and from fees for add-on features such as extra photographs, scheduled end times, etc. Revenue from auction listings has grown by 17% in the year to 30 September 2011.

Classifieds

Trade Me sells classified advertisements in three major categories:

- Motors. Representing 16% of total revenues in FY2011, Motors is the largest of Trade Me's classified businesses. Trade dealers and private owners list new and used vehicles, boats and motorcycles. Revenues from Motors classifieds grew by 3% in the year ending 30 September 2011, presumably reflecting the on-going economic uncertainty.
- Property. Representing 12% of total revenues in FY2011, real estate agents and private sellers list a wide range of property types for sale or rent. Revenues from Properties classifieds grew by 10% in the year ending 30 September 2011.
- Jobs. Representing 7% of total revenues in FY2011, this is the only business line where Trade Me is not the market leader – the Australian-based employment site Seek.co.nz has the leading position in New Zealand (but only by a small margin). Revenues from Jobs classifieds grew by 27% in the year ending 30 September 2011.

Other Businesses

Trade Me has also launched sites around six other verticals, including TravelBug (accommodation), BookIt (accommodation booking engine), Holiday Houses (home bookings), FindSomeone (online dating), Treat Me group buying) and Old Friends (connecting friends and family).

Growth Strategy

The company has identified three categories of growth:

- Internet usage is expected to rise. The company believes Trade Me will benefit from growth in the usage of the internet in New Zealand, primarily driven by the rapid adoption of mobile platforms such as tablet and smart phones;
- Organic growth from existing platforms. The company says it has identified growth opportunities in its existing platforms; and
- Opportunities in new markets. The company has made investments and acquisitions in the past, and management says it will consider further acquisitions to create growth.

Our Views

We believe that Trade Me has several characteristics which make it an attractive opportunity for investors.

Experienced Board And Management

Trade Me's board and management include personnel with in-depth understanding of the company and its industry setting and who drove its historical growth. The board includes the company's founder, Sam Morgan, and the former CEO of Fairfax Media, David Kirk. CEO Jon Macdonald and most of the senior management team have been with the company for several years.

Strong Market Position

Trade Me is the leading player in each of its major businesses – the key exception being in job advertisements where Seek, the Australian-based employment classified site, has a slightly larger market share.

The key to understanding Trade Me's business strength is the network effect generated by the size of its user base. Trade Me's large number of buyers and sellers – in our view particularly the sellers – creates a positive network effect which both underpins Trade Me's business and presents a very high barrier to entry for potential competitors.

This large user base, their trading history and their reputational status, is Trade Me's most significant defensive asset.

Ability To Raise Its Prices To Improve Margins

We believe there is upside in the prices that Trade Me charges its users.

Attractive Dividend Yield

Trade Me's strong earnings and profitability means it can maintain an attractive dividend payout to shareholders. With maturing growth, the ability of the company to deliver big jumps in performance that could translate into significant stock price increases has also diminished compared to the past. As such, we believe that more than half of shareholder return will be in the form of dividend over capital appreciation.

The company has committed to an initial dividend of $0.138 per share, which at the IPO price of $2.70 per share represents an initial yield of 5.1%, roughly in line with other yield-oriented stocks on the NZX. Shareholders will expect the dividend to grow at no less than the rate of inflation.

Despite 80% Dividend Payout Ratio, Cash Accumulates

Our forecast suggests that even with the nominated dividend payout ratio of 80% of NPAT, Trade Me continues to accumulate cash at a rate of approximately $15 million per year. This suggests that, in the absence of significant acquisitions, the board may be able to increase the dividend payout ratio. Alternatively the board could initiate a stock buy-back if it feels that the share price has fallen below its intrinsic value.

Trade Me Could Attract A Takeover Offer

Trade Me's strong cash flows and proven business model could attract interest from potential acquirers. We consider that Trade Me's post-IPO share register – where one shareholder owns 66% of the shares on issue – could encourage such interest, as potential acquirers only need reach agreement with Fairfax in order to secure control of Trade Me. We believe that one of Fairfax's rationales for retaining a majority shareholding is to encourage such takeover offers.

That said, we also believe Trade Me faces several challenges:

Hyper Growth Of The Past Given Way To Mature Growth

Trade Me's annual revenue growth rate has slowed from 40% in FY2007 to less than 10% forecast in the next 12 months.

Our view is Trade Me has reached a stage of maturity, characterised by modest future revenue growth. We expect future growth in the user base will be low – our view is that nearly everyone who wishes to buy, sell or list on Trade Me is either already a user, or accesses the site via friends and family who are already users. We do not expect the development of faster internet access to have a material effect on Trade Me's growth, as the site is optimised for access over dial-up modem speeds.

Margins Are Declining

Trade Me's EBITDA margins have steadily declined from 84% in FY2007 to a forecast margin of 72% in the 12 months ending 31 December 2012.

We expect operating costs will grow at a faster rate than revenues over our forecast period, which will continue to pressure margins.

In terms of other uses of cash, capital expenditure has also been growing steadily, from approximately $3 million to $7 million in the next few years.

Cash-Accretive Acquisitions Will Be Hard To Find

To the extent Trade Me pursues acquisitions as part of its growth strategy, the company will need to acquire companies with strong cash flows and/or growth prospects that are material in the context of Trade Me's own total revenues and earnings.

We expect the challenge to an acquisition-led strategy will be that:

- Other internet companies in New Zealand are likely to offer limited growth potential;
- Successful internet companies offshore are likely to be too large for Trade Me to easily acquire (for example, consider the market capitalisation of the peer companies listed on page 8); and
- Smaller internet companies offshore are likely to have challenging paths to becoming successful defendable businesses; and
- Non-internet companies, either in New Zealand or overseas, are likely to have much lower earnings margins and earnings growth, and pose different management challenges than an internet-based business.

Also, a major acquisition might distract a significant portion of the board and management's attention away from the core business. It would also rely on effective post-merger integration in order to capture the forecast gains for Trade Me's shareholders. While Trade Me has completed a few small acquisitions to date there is a risk of a significant acquisition being a disruptive event in the life of the company.

The Need For Strict Financial Discipline

We expect Trade Me to accumulate cash, even with an 80% dividend payout ratio. This creates the potential for agency costs, where management (the agent) could look to use the company's resources (the cash) in ways that offer little benefit to shareholders. Trade Me's board will and management will need to ensure the company keeps to tight financial disciplines, in order to ensure shareholder value is not eroded.

We also consider there are several market factors which investors in Trade Me should consider:

The Initial IPO Excitement Will Settle Over Time

We expect the Trade Me IPO to be heavily over-subscribed. This suggests the initial supply and demand for the stock will not be in balance and this is likely to put upward pressure on the stock price in the short-term.

But, as the legendary investor Benjamin Graham, said, "In the short term, the stock market behaves more like a voting machine, but in the long term, it acts more like a weighing machine." In other words, a company's share price should, in the longer run, accurately reflect its intrinsic value. As such, we expect that once demand and supply have reached equilibrium Trade Me's share price will settle to its longer-term rational value.

Increasing Interest Rates Will Likely Decrease Share Price

As with any yielding stock, Trade Me will be sensitive to interest rates.

Interest rates are currently at historically low levels. However, as the world's economies begin to recover from the current financial crises central banks will likely start tightening rates again to control inflation, and as interest rates rise, yield-oriented stocks typically fall.

Trade Me's Capital Structure At The IPO Is Sub-Optimal

Trade Me will list on the NZSX with approximately $166 million of new bank debt, representing approximately 20.8% of gearing (measured as debt divided by the book value of equity plus debt) and a Net Debt/EBITDA ratio of a conservative 1.6x.

Trade Me's current loan agreement includes two financial covenants that would limit significant leveraging. However, these covenants could be easily replaced under a new loan agreement.

Given Trade Me's strong earnings we believe the company could readily support in the order of a further $300 million of senior and subordinated debt. Such a levered capital structure would boost returns on equity. The board could use this incremental debt capacity to fund acquisitions, a special dividend or to finance a stock buy back.

At Fairfax's recent AGM, their Chairman announced Fairfax will continue to de-lever their balance sheet. As the 66% controlling shareholder, it is possible Fairfax could decide to lever up Trade Me's balance sheet in order to extract a dividend to use to de-lever its own balance sheet.

While all of Trade Me's shareholders would benefit from such a dividend the longer-term impact would be to divert a larger portion of the company's cash flow to service debt, making less available for dividends. While leverage does theoretically increase return to equity, on a cash basis, the reduced dividend will also reduce the current income, in turn putting downward pressure on the stock price.

Effective Competitors Could Emerge

Trade Me's strong profitability may ultimately attract competitors in one or more of the company's businesses. That said, Trade Me has a number of defensive characteristics which would make it hard for competitors to capture material market share from Trade Me.

Forecasts & Valuation

Forecasts

In preparing a base case forecast, we have first considered Trade Me's historical performance:

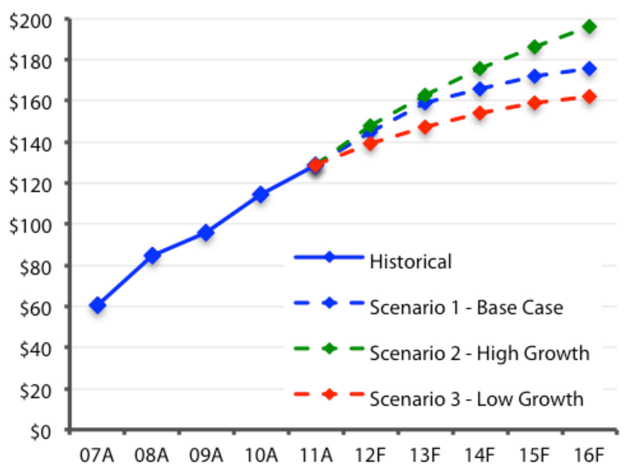
FY ended 30 June		07A	08A	09A	10A	11A
Revenues	($m)	60.5	84.6	96.1	114.4	128.8
Y-o-y growth	(%)	n/a	39.8	13.6	19.0	12.6
EBITDA	($m)	50.7	69.8	77.7	90.1	98.1
EBITDA margin	(%)	83.9	82.5	80.9	78.8	76.2

Taking into account these figures and management's forecasts, we have prepared base case financial forecasts that reflect our expectations of Trade Me's future performance, based on the following three scenarios:

We have developed three forecast scenarios for Trade Me:

- **Base Case** – Revenue growth gently tapers off to $175.8 million of revenue in FY2016.
- **High Growth** – Stronger continued revenue growth, to revenues of $195.9 million in FY2016.
- **Low Growth** – Faster fall-off in revenue growth, with $161.9 million of revenue in FY2016.

The historical and forecast revenues in the three scenarios are:



In all three scenarios, we have assumed:

- Capital expenditure of $7.0 m for FY2012 and growing at the rate of inflation (2%); and
- Term debt of $166.0 m over the forecast period.

Cost Of Capital

We have estimated Trade Me's weighted average cost of capital (**WACC**) to be 9.4% pa post corporate tax.

We have derived a cost of equity using the simplified Brennan-Lally version of the Capital Asset Pricing Model (**CAPM**) using the following inputs:

Cost of Capital Assumptions for DCF Valuation	
Cost of debt (k_d)	6.1% pa
Risk-free rate	5.0% pa
Equity beta (estimated)	0.84
Post-tax market risk premium	7.5% pa
Corporate tax rate	28.0%
Resident withholding tax rate	28.0%
Post-tax cost of equity (k_e)	9.9% pa
WACC	9.4% pa

Valuation

Our valuation analysis suggests an equity valuation for Trade Me of $2.54 per share.

This figure is based on our base case forecast and the following weighted blend of three valuation approaches:

- 40% of the share price implied by the discounted cash flow (**DCF**) analysis;
- 20% of the share price implied by the average of the EV/EBITDA multiples of six comparable listed companies; and
- 40% of the share price implied by the average of the current yields of 18 other dividend-paying stocks on the NZSX.

The equivalent analysis for our High Growth scenario suggests an upper bound valuation for Trade Me of $2.71 per share. And the equivalent analysis for our Low Growth scenario suggests a lower bound valuation for Trade Me of $2.42 per share.

These three valuation approaches produced the following individual results:

DCF Analysis Suggests A Valuation Of $2.61 Per Share

Our DCF analysis of the base case financial forecasts produces an enterprise value (**EV**) for Trade Me of $1.199 billion.

DCF Valuation As At 30 June 2011		
WACC		9.4% pa
Long-term growth rate (nominal)		2.25% pa
Present value of the free cash flows in the forecast period	$	336 m
Present value of the terminal value	$	862 m
Enterprise Value	**$**	**1,199 m**
Net debt	$	166 m
Equity value	$	1,033 m
Number of shares outstanding		396.0 m
Equity value per share	$	2.61

Earnings Multiple Analysis Suggests A Valuation Of $2.46 Per Share

Valuation metrics from comparable listed companies (set out on page 8) suggests an average EV/EBITDA (current year) multiple of 10.85x.

This suggests an enterprise value for Trade Me of $1.138 billion. This equates to a share price of $2.46 per share.

Dividend Yield Analysis Suggests A Valuation Of $2.52 Per Share

Finally, we have derived a valuation of Trade Me based on the dividend we expect Trade Me to pay over the 12 months following the IPO, considered in comparison to comparable yielding stocks on the NZSX (set out on page 8).

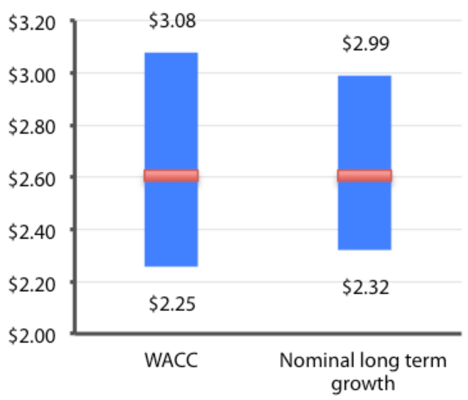
The comparable companies have an average dividend yield of 5.47% pa. Applying this yield to Trade Me's expected dividend for the next twelve months suggests a share price of $2.52 per share.

Sensitivity Analysis

We have tested the sensitivity of the share price valuation to changes in two key inputs:

- WACC; and
- Terminal growth rate.

The effect of ±1% changes in these valuation inputs on the equity value is:



Conclusion

- Trade Me is the dominant player in all but one of its business lines (Job advertisements).
- The company has a board and management team with proven track records at Trade Me.
- Trade Me's revenue growth rate is slowing and its margins are declining.
- But Trade Me still has the highest EBITDA margin of all NZSX-listed companies.
- Most of the returns to shareholders are likely to come in the form of dividends rather than capital appreciation.
- As a yield oriented stock, Trade Me will be sensitive to rising interest rates.

Financial Summary

Financial year end 30 June		2011A	2012E	2013E	2014E	2015E	2016E
Valuation Ratios							
EV/EBITDA adjusted	(x)	12.0	11.2	10.4			
EV/EBIT adjusted	(x)	12.4	11.8	11.0			
P/E adjusted	(x)	15.5	15.5	15.2			
P/Book Value	(x)	53.7	1.7	1.7			
Dividend yield	(%)	0.0	3.8	5.3			
Per share data							
EPS reported	($)	0.18	0.17	0.18	0.19	0.19	0.20
EPS adjusted	($)	0.17	0.17	0.18	0.19	0.19	0.20
Book Value per share	($)	0.05	1.59	1.63	1.67	1.70	1.74
Dividend per share	($)	0.00	0.10	0.14	0.15	0.15	0.16
Profit & Loss	($m)						
Total revenues		128.8	144.8	159.0	166.0	172.0	175.8
Operating expenses		-30.7	-39.9	-45.8	-48.0	-49.8	-50.8
EBITDA		**98.1**	**104.9**	**113.2**	**118.0**	**122.2**	**125.0**
Depreciation & amortisation		-3.5	-5.3	-6.6	-7.0	-7.4	-7.6
EBIT		94.6	99.6	106.6	111.0	114.8	117.4
Net interest expense		5.6	-4.5	-9.6	-9.6	-9.6	-9.6
Pre-tax profit (NPBT)		100.7	95.6	97.5	101.9	105.7	108.3
Tax		-31.5	-26.8	-27.3	-28.5	-29.6	-30.3
Extraordinary items & one offs		0.6	0.0	0.0	0.0	0.0	0.0
Reported after-tax profit (NPAT)		**69.8**	**68.8**	**70.2**	**73.4**	**76.1**	**78.0**
Adjusted EBITDA		98.1	104.9	113.2	118.0	122.2	125.0
Adjusted after-tax profit (NPAT)		69.2	68.8	70.2	73.4	76.1	78.0
Cash Flow	($m)						
Earnings		98.1	104.9	113.2	118.0	122.2	125.0
Tax		-16.7	-26.8	-27.3	-28.5	-29.6	-30.3
Other cash flows from operations		6.3	-14.5	2.1	1.5	1.4	1.3
Cash flows from operations		**87.7**	**63.6**	**88.0**	**91.0**	**94.0**	**96.0**
Capital expenditure		-6.9	-7.1	-7.2	-7.5	-7.8	-8.2
Other cash flows from investing		-78.3	30.2	0.0	0.0	0.0	0.0
Cash flows from investing		**-85.2**	**23.1**	**-7.2**	**-7.5**	**-7.8**	**-8.2**
Interest paid		0.0	-5.2	-10.4	-10.4	-10.4	-10.4
Debt drawn-down/(repaid)		0.0	166.0	0.0	0.0	0.0	0.0
Dividends		0.0	-41.0	-56.2	-58.7	-60.9	-62.4
Equity issued/(bought-back)		0.0	363.5	0.0	0.0	0.0	0.0
Other cash flows from financing		0.0	-529.5	0.0	0.0	0.0	0.0
Cash flows from financing		**0.0**	**-46.2**	**-66.6**	**-69.1**	**-71.3**	**-72.8**
Net change in cash		**2.5**	**40.5**	**14.2**	**14.4**	**14.9**	**15.0**
Closing cash		**6.0**	**46.5**	**60.7**	**75.1**	**90.0**	**105.0**
Balance Sheet	($m)						
Cash & cash equivalents		6.0	46.5	60.7	75.1	90.0	105.0
Accounts receivable		3.8	3.5	3.9	4.0	4.2	4.3
Other current assets		39.5	0.0	0.0	0.0	0.0	0.0
Fixed assets		4.2	5.1	5.6	6.1	6.6	7.2
Other non-current assets		8.5	759.1	759.2	759.2	759.1	759.1
Total assets		**62.0**	**814.2**	**829.4**	**844.4**	**859.9**	**875.6**
Accounts payable		-6.1	-8.3	-9.6	-10.0	-10.4	-10.6
Interest bearing debt		0.0	-166.0	-166.0	-166.0	-166.0	-166.0
Other liabilities		-36.0	-8.6	-8.6	-8.6	-8.6	-8.6
Total liabilities		**-42.1**	**-182.9**	**-184.2**	**-184.6**	**-185.0**	**-185.2**
Book value of equity		**19.9**	**631.3**	**645.2**	**659.8**	**674.9**	**690.4**
Key Ratios	(%)						
EBITDA margin adjusted		76.2	72.4	71.2	71.1	71.0	71.1
ROE adjusted		6.5	6.4	6.6	6.9	7.1	7.3
ROIC		n/a	5.6	5.7	5.9	6.2	6.3
Net debt to total capital (D/D+E)		0.0	20.8	20.5	20.1	19.7	19.4
Revenue growth rate		12.6	12.4	9.8	4.4	3.6	2.2
EBITDA growth rate adjusted		8.9	6.9	7.9	4.2	3.6	2.3

All dollar value figures shown here are in nominal dollars, ie they include the effect of inflation

Peer Group

Listed Comparatives		Average	eBay	Seek	Wotif	REA Group	Carsales.com	NZX
Company Information								
Domicile			USA	Aus	Aus	Aus	Aus	NZ
Ticker			NAS:EBAY	ASX:SEK	ASX:WOT	ASX:REA	ASX:CRZ	NZX:NZX
Financial year end			31-Dec	30-Jun	30-Jun	30-Jun	30-Jun	31-Dec
Performance In Last FY	($m)							
Revenue			9,156.3	344.7	138.4	238.4	153.5	50.2
EBITDA			2,816.1	122.7	77.7	107.8	84.8	19.3
EBIT			2,053.6	110.2	71.6	97.3	82.1	14.6
Performance In Current FY (Analyst Consensus)	($m)							
Revenue			11,582.1	423.9	146.4	275.1	174.6	55.3
EBITDA			3,783.9	182.5	81.8	121.4	96.2	26.1
EBIT			3,012.0	176.3	75.6	109.7	93.2	21.0
Market Valuation	($m)							
Market capitalisation			40,251.3	2,029.2	750.0	1,672.8	1,172.2	281.5
Enterprise value			38,782.5	2,329.1	616.5	1,539.5	1,139.4	262.3
Valuation Metrics								
Equity Beta			1.18	1.05	0.84	0.42	0.86	0.87
EV/Revenue current FY	(x)	**4.99**	3.35	5.49	4.21	5.60	6.53	4.74
EV/EBITDA current FY	(x)	**10.85**	10.25	12.76	7.53	12.68	11.85	10.05
EV/EBIT current FY	(x)	**12.17**	12.88	13.21	8.15	14.03	12.23	12.52

Listed Yield Comparatives - Utilities		(%)
Contact Energy	NZX:CEN	4.10
Trustpower	NZX:TPW	5.45
Horizon Energy	NZX:HED	5.15
Vector	NZX:VCT	5.38
Listed Yield Comparatives – Infrastructure		
NZX	NZX:NZX	5.13
Port of Tauranga	NZX:POT	3.22
Auckland International Airport	NZX:AIA	3.77
Northland Port	NZX:NTH	4.48
Infratil	NZX:IFT	3.64
Listed Yield Comparatives – Property/Retirement Village Operators		
Ryman Health	NZX:RYM	2.78
Property for Industry	NZX:PFI	6.08
AMP NZ Office	NZX:ANO	6.18
DNZ Property Fund	NZX:DNZ	6.25
Kiwi Income Property Trust	NZX:KIP	6.51
Goodman Property Trust	NZX:GMT	7.10
ING Property Trust	NZX:ARG	8.28
The National Property Trust	NZX:NPT	9.01
Average		**5.47**

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