VITA GROUP INVESTOR REPORT

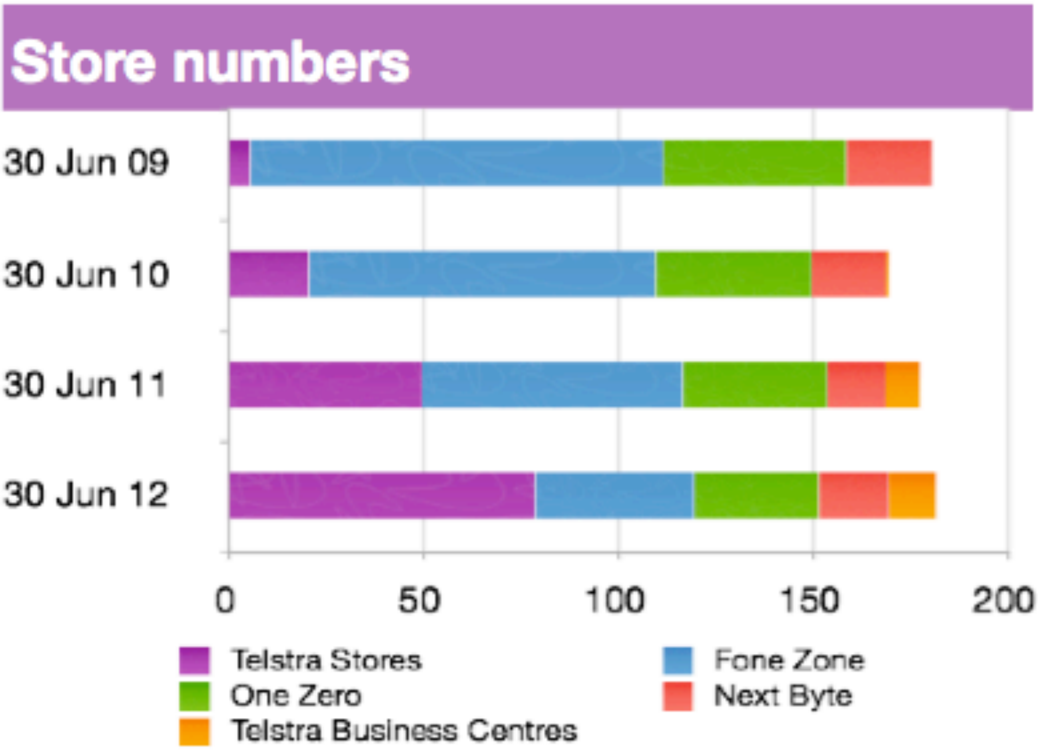
By Harley Grosser

Most of us have a set list of criteria with which to analyse potential investment opportunities. We look for clean financial statements with growing profits that match cash flows, high and sustainable returns on equity and low or no debt. These kinds of companies jump out at you as they are relatively simple to identify and easy to analyse. Companies like ARP, COH and CSL come to mind. When you find a company like this your job is to purchase at a discount to what it is worth. Should you do so successfully you will come as close to a guaranteed positive return as is possible in this investment game.

The only downside to these kinds of investments is that they are rarely cheap and when they are the discount on offer is usually relatively small. Outside of an event like the GFC or the European debt crisis that temporarily blinds the market from seeing obvious value it is unlikely that companies such as these will present you with the opportunity to make two, three or four times your money over a relatively short period. The reason being that if the value is plain for all to see, chances are the market is aware of it and has priced it accordingly.

If you want to generate outsized returns you need to find value in investments that the market is yet to acknowledge. But sometimes these opportunities don't jump out at us, rather we need to go looking for them, digging beneath the headline numbers and looking beyond the general consensus in order to see opportunity where others do not. It is these types of investments that hold the potential for the greatest returns, meaning the increased time and effort required is well worth it when a genuine opportunity of this nature comes along. Vita Group may be one such opportunity.

Vita Group (ASX:VTG)
Vita Group is a telecommunications and computing retailer that encompasses six brands - Fone Zone, One Zero, Next Byte, iConcierge, Vita Networks and Sprout Accessories– along with selected Telstra Shops and Telstra Business Centres. The Vita store portfolio currently comprises a total of 182 stores, with the breakdown of the store count shown in the graphic below.



	30 Jun 09	30 Jun 10	30 Jun 11	30 Jun 12
Telstra Stores	6	21	50	79
Fone Zone	106	89	67	41
One Zero	47	40	37	32
Next Byte	22	19	15	18
TBC	0	1	9	12
Total Stores	**181**	**170**	**178**	**182**

The Vita Story

In 1995 Maxine Horne and David McMahon, who today hold 45% of the company, founded Fone Zone and were the first in Australia to establish a mobile phone retailer inside a shopping centre. Helped along by the rapid growth in mobile phone demand Fone Zone grew tremendously from a single store front in 1995 to 123 stores just ten years later. At the time of listing in November 2005 Fone Zone had secured its place as the largest independent handset and associated accessories retailer in Australia.

In August 2007 the company purchased Next Byte, Australia's largest specialist Apple retailer, for around $31m (which in accordance with the theme of pre-GFC debt fueled acquisitions looks, in hindsight, overpriced). The acquisition of Next Byte and the introduction of other brands into the Vita Group portfolio lead Fone Zone to change it's name to Vita Group (which is latin for “Way of life”) to better reflect its transition from a pure retailer of mobile handsets to the new composition of the company as a retailer of both telecommunications and computing products and services.

The company performed well until the global economy began to turn sour in 2007/08. Like virtually all Australian retailers Vita felt the effects of the GFC, yet were able to register a modest profit after tax in FY09. More importantly 2009 marked the beginning of the transformation that is only now nearing completion and has positioned Vita as a retailer with strong relationships with two of the most powerful players in the Australian technology market - Telstra and Apple.

In FY09 Vita strengthened their ongoing relationship with Telstra by securing the master license for Telstra’s retail stores. In addition to closing 33 Fone Zone stores over the period the company also began the rollout of Telstra shops bringing the count to a total of 22 by the end of FY10 with many more soon to follow. The agreement with Telstra was later adjusted to allow for its term to be extended for up to 9 years provided the stores were rolled out successfully and in accordance with Telstra’s high standards.

Since the transformation began in 2009 Vita’s store count has remained relatively constant rising from 181 to 182 points of presence. Yet despite this minor increase total revenue has jumped 38% from $297m in 2009 to $410m in 2012, driven by the rollout of Telstra stores either through conversion of existing Fone Zone stores, acquisition of licenses or greenfield projects.

The rollout of Telstra stores has driven the transformation of the company and with the current Telstra store count nearing the company’s long term target of 100 stores the process is near complete. As a result of this transformation, as well as what management have planned for Next Byte, the company’s performance going forward will look very different to what we have seen in the recent past.

The Vita Plan

As mentioned management have indicated their target of 100 Telstra stores, in line with the agreement made with the leading mobile service provider in Australia. While there are currently no plans for further Telstra stores beyond the planned 100 there exists the potential for growth beyond this number should the company continue to impress Telstra and both companies see expansion as mutually beneficial. In this regard it should be noted that Telstra have made known that they are pleased with the rollout to date, with Vita’s Telstra stores exceeding customer service standards used internally by Telstra.

In addition to the Telstra store rollout Vita have undertaken a dramatic revamping of the Next Byte business, with underperforming stores being closed and a new model as an Apple Premium Reseller (APR) being unveiled. There are now five Next Byte APR stores with another four to be opened in the first half of FY13. In FY12 Vita wrote down the carrying value of Next Byte by $15m to better reflect its future earnings potential.

The business model for this company is obvious - establish and maintain relationships with two powerhouses in technology and leverage the company’s performance to the success of these giants in the telecommunications and computing industries. It is these relationships that have allowed Vita to continue to grow their sales revenue and underlying EBITDA in a retailing environment where most companies would be happy just to see their performance remain stable.

The Telstra Effect

Regardless of what you may think of Telstra in regards to its fixed line and internet businesses there is no denying the fact that Telstra dominates the mobile market in Australia. Their strong performance persisted over the prior twelve months with Telstra continuing to steal market share off its competitors, namely Optus and Vodafone. In the last two years Telstra has increased its mobile customer base by 3.2 million as a result of its superior infrastructure, and no doubt helped along by the PR catastrophe that occurred at Vodafone.

The issue at heart is a simple one. Telstra provides the best coverage Australia-wide so for consumers who have a need for top quality reception Telstra is the pick of the bunch. The issue of reception is even more relevant in regional areas where many of Vita's stores are located and Telstra reins as the leader in service coverage. For many consumers when it comes time to get a new phone the simple solution is to visit the nearest Telstra store.

The next step for Telstra involves the roll out of their new 4G network which began last September and currently covers around 40% of the population, with plans recently announced to take that figure to 66% by the middle of next year. Telstra's main competitor, Optus, is unable to extend it's 4G network into regional areas and as events stand today will not be able to do so until at least 2015, which bodes well for Vita's regionally focused store portfolio. Ultimately for Vita any action that further solidifies Telstra's position as the leader in mobile services is positive for the company as a partner and now a very significant part of Telstra's retail initiatives.

The Apple Effect

Apple stands as a testament to the consumers willingness to pay for quality. In the face of global recessions, government debt crises and declining consumer spending Apple, through enormous growth in the sales of iPhones, iPads, iPods and Macbooks, have now become the most valuable company in human history when viewed from a market capitalisation basis.

In the process Apple has built a substantial competitive advantage and have acquired an army of what some commentators term 'fan boys' (and girls). This army of Apple lovers are about as loyal as consumers can be and wouldn't be seen dead with a Samsung Galaxy or Blackberry - rather they would prefer to continue to use an old, outdated and even screen-damaged Apple iPhone until the company decides to release the latest version from their smartphone range. While it might sound extreme to some it is no exaggeration - no doubt many have put off the purchase of a new mobile phone over the last financial year as they awaited the much anticipated release of the iPhone 5. While this would have had a negative impact on Vita's revenues in FY12 (and is likely reflected in their like for like sales performance) it could have the opposite effect in FY13, which will be further expanded upon in a moment.

While the telecommunications division is the main driver of earnings for Vita Group the computing division plays a crucial part in the group's performance, contributing around 25% of total revenue. As mentioned earlier Vita have begun opening their new Next Byte APR stores, which from all reports have far more attractive metrics than the old store concept (see graphic below).

Performance new APR v old format stores	
Prospects	2.3 times greater
Revenue	1.3 times greater
Attach accessories	1.2 times greater
Attach connectivity	4.1 times greater
EBITDA	1.8 times greater

The emphasis has been placed firmly on delivering a premium level of service to the customer, with a number of initiatives being established to complement their in-store offering. An example of this is iConcierge which offers services such as repairs, installations and general technology solutions. The concept of the Next Byte APR stores looks to be very similar to the incredibly successful Apple store model. In addition to a similar store layout and experience Vita intends to provide quality service offerings both to the retail market and business customers, the latter of which is set to become a focus for the company in FY13.

The location of Vita's Next Byte stores is integral to their success. Put simply, trying to compete directly with an Apple store is not a good idea. Apple products are universally loved but if a consumer has a choice between purchasing directly from an Apple store or from an Apple Premium Reseller they are likely to choose the former - after all, Apple stores are the most profitable stores in America per square foot for a reason. As a result Vita will look to open stores where Apple are unlikely to do so. While Apple do not release their store location plans to any external source one can assume that through Vita's meetings with Apple management their plans for store locations are unlikely to conflict. Apple itself will contribute to the Next Byte APR store rollout which they would be unlikely to do if they planned to set up shop next door. When this was mentioned on a recent investor conference call by an analyst questioning how Vita can be sure that Apple won't establish stores nearby the Vita joint CEO David McMahon replied simply "We agree with your logic." As an investor it is likely safe to assume that Apple's declaration of its planned store locations is shared implicitly, rather than explicitly, with its operating partners such as Vita.

Vita wish to establish Next Byte APR as the next best alternative to the real thing. And by positioning their stores in locations where the best option - an Apple store - is not present then the Vita offering becomes the go to option for Apple lovers and consumers in general. One thing is for sure that as a retailer if there is one brand you would want to be selling in the current retail environment, it is Apple.

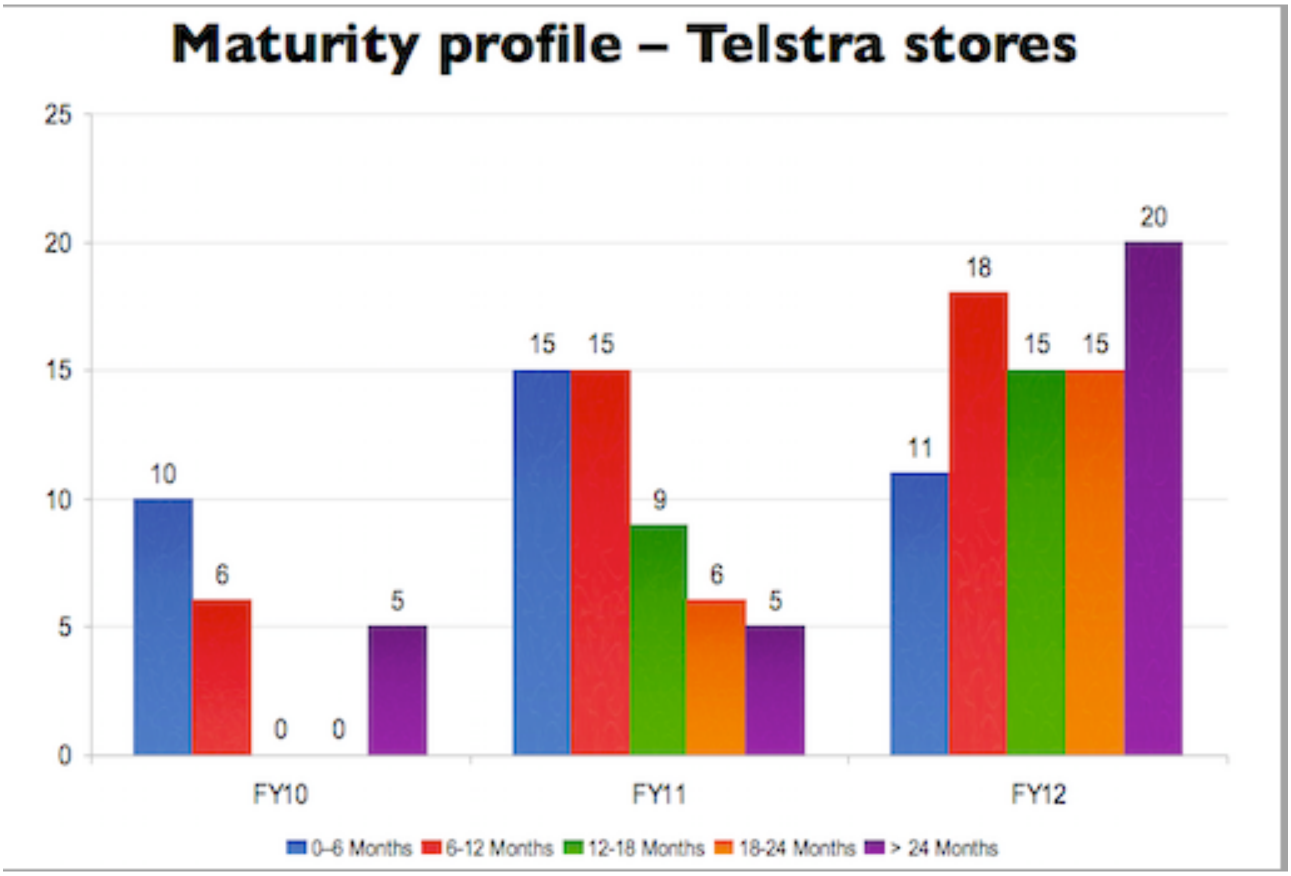
Crouching Profits, Hidden Growth

Having established Vita's strong qualitative fundamentals we must now turn to the quantitative factors of the company and it is here where the story becomes interesting. There are a number of issues at play that mask the underlying growth that this company has experienced in recent years which has resulted in the headline figures drastically understating the company's trend line growth rate across a number of metrics.

As previously noted Vita's sales have increased 38%, or $113m, since 2009 despite the total store count increasing by just one to 182. But a look at sales by segments reveals a far more dramatic growth story. Since 2009 telecommunications revenue has increased from $169m to $303.2m, while computing revenue has fallen from $128.5m to $107.2m reflecting the closure of a number of Next Byte stores. The 38% increase in total sales was registered despite a 16.5% drop in computing revenue thanks to a staggering 80% increase in telecommunications revenue, the latter of which was achieved with total store count for the telecommunications division increasing by just 5 stores from 159 to 164.

While the Telstra store rollout has been the primary driver of the massive growth in telecommunications revenue the associated expenditures have put pressure on the company's after tax profit. Underlying EBITDA growth has been stellar rising 68% in FY11 and 89% in FY12. Under normal circumstances companies advertising their EBITDA growth over their NPAT results need to be viewed skeptically, but in the case of Vita it is arguably justified due to the high level of capex required throughout the current period. Importantly for investors capital expenditures are expected to peak in FY13 as are depreciation expenses and gross debt levels, meaning the focus should soon turn away from EBITDA to the more investor friendly NPAT.

The maturity of the Telstra stores that are continuing to be rolled out will comprise the primary source of growth for the company. The graphic below shows the maturity profile of the Telstra store portfolio for Vita as at 30 June 2012.



According to management's estimates Telstra stores typically take two years to mature, at which point investors can expect the full profitability of these stores to begin to flow through to the bottom line. As we can see from the maturity profile above the next 12 months will see a further 30 stores reach maturity, with another 29 to follow in FY14. By the end of FY13 half of the total 100 stores planned by Vita will have reached maturity and will have progressed beyond the high capex stage of development to a more stable and profitable earnings profile. This is one of the primary reasons why investors can expect to see rising profits and expanding margins begin to accrue in the current financial year. Of course at the end of FY13 another 50 stores will still be yet to mature meaning investors should not expect the full benefits of the Telstra store rollout for at least another 12-24 months.

Perhaps the most significant issue that has served to mask Vita's growth story relates to a change in the payment methods made to the company by Telstra. In 2009 the commission structure was changed from trailing commissions to higher upfront payments. As a result Telstra agreed to pay Vita $23.6m over an 18 month period in lieu of Vita's then current future trailing commission entitlements. In other words in 2011 Vita were still receiving cash from business conducted in prior years. The upside to this was that Vita used the cash to fund the Telstra store rollout however the result of having this cash flowing into the company is that it has masked the growth that Vita has experienced since embarking on the transformation process that commenced in 2009, hence the need to look at underlying EBITDA to reveal the true growth rate. For example, in FY12 Vita generated $17m in surplus operating cash flows. This is a pleasing result even considering the rise in trade payables and unearned revenue as it reflects an underlying increase over the previous year and an acceleration from the first half of FY12. However, due to $9m of cash being received in 2011 from trailing commission entitlements the accounts show that operating cash flows have fallen from $18m in FY11 to $17m in FY12, masking the underlying growth.

Another hidden facet of the Vita balance sheet relates to the timing of payments and receipts. Take a look at the working capital position of Vita and you will notice the difference between payables and receivables. This discrepancy has existed for some time, the extent of which can be easily determined by a look back at previous years financial statements. At first glance one would understandably perceive this to be a risk to investors, but they may be mistaken to do so. The reason for the substantial difference between payables and receivables is due to the nature of payments made and received by the company. Vita receive payment at point of sale but pay their suppliers on terms, causing payables to outweigh receivables. Up until now the cash that would have built up as a result of the timing of payments and receipts has been deployed in the store rollout process and its associated expenses. In time, with ongoing strong performance and as debt repayments and other significant expenditures decline, investors can expect this perceived weakness to be shown to be a strength, as there is no doubt that many retailers would be envious of similar payment terms.

Finally, the $15m impairment to the carrying value of the Next Byte business in the second half of FY12 meant that Vita reported a loss of $12m at 30 June 2012. This write down is the result of past performance and does not impact the company's prospects going forward. It represents management's acknowledgement that they paid too much for Next Byte back in 2007 and by taking the write down now they set the business up for higher profits and returns on equity in the future.

Ironically the factors that have conspired to hide Vita's underlying growth and successful transformation process are also responsible for presenting what may be a significant opportunity for investors. Remember, the obvious investments are priced accordingly and for outsized returns investors need to look beyond the headline numbers at the companies that others may overlook. The response to Vita's reported $12m loss in FY12 is a stark example of this, as it was largely the result of the $15m impairment to Next Byte's carrying value. Without the impairment charges the company would have registered a profit of $3.4m for FY12, with the majority being registered in the second half and run rate earnings trending higher as the financial year came to an end. Despite forewarning of the write down being announced weeks in advance the share price still reacted by falling 15% in response to seeing a headline loss, but quickly rebounded in the days that followed. Taking the time to closely examine historical accounts and the financial performance of the company may take far more time and effort but if your analysis is correct the rewards may be well worth it.

An Eye On Margins

In order to best analyse Vita's margins we need to look at gross margins and net profit margins individually, as there are a number of factors at play influencing them separately. If you look at Vita's margins over the years you will notice two main things. The first is that there have been instances where gross margins have been volatile, which suggests some level of risk to the investor. The second is that net profit margins, even when accounting for impairment charges, have been thin and for a company pulling in almost half a billion dollars one would expect profits greater than those that have been registered in recent periods.

Essentially Vita is in a low margin business acting as a sales agent for both Telstra and Apple. The relationships with these companies represent significant competitive advantages for Vita and high barriers to entry for Vita's competitors but they come at a cost, of which relatively thin margins on many of Vita's products is certainly one. Vita are to some extent at the whim of Telstra and Apple in regards to the gross margins they can generate. Telstra alter the fees, commissions and margins on products based on what products or services they wish to incentivise Vita to sell. This can and has resulted in volatility of Vita's gross margins on major products across subsequent reporting periods as Vita is forced to adjust to the changes in margins, fees and commissions. Telstra, and to a lesser extent Apple, are in control of Vita's gross margins and hence a significant portion of the company's potential profitability. While the potential for volatile gross margins over the short term may appear to be a key risk for Vita this is not necessarily the case. Ironically, in the long run, their relationship with Telstra has the opposite effect as Telstra will ensure that Vita can maintain profitable margins since Vita now represents a substantial part of their retail initiatives. A similar situation exists in Vita's relationship with Apple as the tech-giant is actively involved in the roll out of the new Next Byte APR stores and thus has a financial stake, albeit minute for Apple's standards, in Vita's profitability. As a result the short term volatility of Vita's gross margins is less of a risk than it appears at first glance.

The situation in regards to net profit margins is very different. To a large extent investors in Vita are heavily reliant on management's ability to control costs, which has been a focus since the first half of FY12 and saw significant cost reductions in the full year result. Depreciation and finance costs reflecting the ongoing rollout of Telstra and Next Byte APR stores represented substantial drags on net profit in the FY12 result and would be expected to remain relatively high over much of FY13. This is simply a necessary evil of the store expansion process as Vita have decided to fund the rollout through operating cash flows and financing facilities, rather than turn to shareholders for capital. We must also acknowledge the massive transformation process underway since 2009 in which 81 Fone Zone and One Zero stores have been closed or converted and associated expenses incurred, which would be enough to put pressure on the margins of any business. The upside to this situation is that the expansion and transformation process is nearing completion and the benefits will soon flow through to investors as depreciation and finance costs begin to decline just as sales from new stores come through and established stores reach maturity. This is expected to begin in FY13 as debt and capital expenditures peak in the first half of the current financial year and begin their gradual decline.

Again, investors need to be aware that Vita is an opportunity that requires looking forward rather than basing one's projections on what has occurred in the recent past. On average Telstra stores mature in two years while Next Byte stores generally achieve cash payback slightly quicker at around 1.5 years. With 30 Telstra stores maturing in FY13 and a further 29 in FY14 investors can expect margins to improve for the telecommunications division. Once all Telstra stores have been rolled out, and provided Next Byte APR proves successful in its own store rollout process, we will likely see a significant amount of expansion related expenses stripped away and Vita revealed as a very profitable company.

While the outlook appears promising this process takes time and investors should not expect what management refer to as "optimisation of the income statement" until FY14, and from the perspective of an unbiased analysis of Vita's accounts, perhaps not until early FY15. Regardless it is likely that the peak in this highly capital intensive period for Vita is either behind us or will occur in the first half of FY13, after which investors can expect higher returns on capital and improving net profit margins.

Where things get really interesting is that the timing of major product releases, the expiry of a large number of mobile contracts, the beginning of the rollout of Next Byte APR, the opening of the final Telstra stores and the maturity of a substantial number of established stores all look likely to occur in FY13. The release of the iPhone 5 just as many consumers come off contract could result in a dramatic boost to sales akin to what we saw in FY11. If this were to occur it would have the potential to more than compensate for the high level of costs predicted for FY13 and would mean that Vita could begin generating 'optimised' returns one year earlier than is currently expected.

Cyclicality Of Earnings

FY12 was a tough year for retailers and while Vita's overall revenue growth of 6% and telecommunication's increase of 20% year over year suggests the company was able to buck the trend there is more to it than meets the eye. While headline revenue increased in FY12 this is almost entirely due to the store rollout process and the improving quality of the store portfolio. Regardless, the fact that other major retailers proclaimed FY12 to be the toughest year in recent memory yet Vita still registered revenue growth, even if primarily the result of more stores, is testament to both strong management and the attractiveness of the sectors in which Vita is operating.

While total revenue growth was strong, and telecommunications particularly so, the story is very different on a like for like basis. While FY11 was a stellar year for Vita's telecommunications division FY12 was notably slower. There is however, a logical explanation for this occurrence. The mobile phone business is far more cyclical than most would assume. Many consumers put off the purchase of a phone in FY12 in anticipation of the iPhone 5. No doubt many were waiting for the iPhone 4 to be released before purchasing a new phone and rushed out to get one upon its release to the public. It is no coincidence that Telstra's increase in market share began in the middle of 2010, coinciding with the release of the iPhone 4 and one of its main competitors at the time, the Samsung Galaxy S. This leads to the observation that while the market share of the major phone providers is determined mainly by the quality of service that they offer, the timing of significant movements in market share amongst these providers is not determined by

Telstra and its peers, rather it is being determined by the schedule of release of new products from the two market leaders - Apple and Samsung - and how the timing of these releases relate to the contract lengths of customers.

We saw what the release of a couple of top selling products can do for Vita's sales performance in 2011 when the release of both the iPhone 4 and the Samsung Galaxy S drove an increase of 41% for Vita's Telstra stores and 40% for Fone Zone on a like for like basis. With the average contract lasting 24 months the majority of the consumers who chose a plan assigned to either of these phones was still under contract throughout FY12, which explains Vita's lower like for like sales performance over the year where Telstra remained flat and Fone Zone registered softer like for like sales. However, from the middle of this year those early adopters of iPhone's and Galaxy's will begin to come off contract, meaning the cycle will start once again. The expiration of what is forecast to be 8 million contracts, half of which are currently assigned to iPhone 4's, will coincide with the release of the iPhone 5 and the Galaxy S3, as well as a number of other products from competitors looking to knock the two market leaders of their perch. This leaves open the possibility of substantial earnings growth in the current financial year beyond what is already expected. If the following quotes from Vita employees regarding the recent release of the iPhone 5 are anything to go by, it appears iPhone 5 sales are on track to meet expectations*:

"There were 50 people waiting out the front of the shop on Friday...As soon as we get stock in it is basically walking out the door that day." - **Telstra Store, Kingaroy**

"We're out of stock. We sold 55 in the first two days." **Telstra Store, Rockhampton**

"We sold out on Friday in an hour and a half." **Fone Zone, Griffith**

"We are out of stock, but get more in today or tomorrow. Yes, it totally lived up to the hype." **Next Byte, Sydney CBD**

"Based on sales, yes it did (live up to the hype). We have sold 200 since Friday and are basically out of stock...No one wants to look at it, they just buy it. It makes my job the easiest in the world." **Telstra Store, Forest Hill**

"We are short on supply and could definitely use a lot more than we received...The majority of people who have one (an iPhone) get the next model as soon as it comes out." **Telstra Store, Hobart**

"We are out of stock since Friday but expecting more in soon...We also saw a pick up in the sale of the iPhone 4s, which is now being sold outright." **Next Byte, Mackay**

*Readers should be aware that Apple limit stock so that stores sell out quickly. Nevertheless the quotes provide a good indication of the popularity of the iPhone 5 and the sales registered by Vita-owned stores in the days and weeks post-release.

On The Terms Of The Telstra Contract

When Vita signed the master licensing agreement with Telstra for the rollout of the T-life stores in August 2009 the contract was for a period of up to 9 years, consisting of a five year agreement with four one-year options, with the contract being applied on a store-by-store basis. The way the contract works is that the store rollout process is progressed over four phases, with each phase spanning roughly the course of a year. At the end of each of these successful one year periods (rollout phases) the five year agreement is moved out an extra year. In other words, as Vita successfully completes each phase of the store rollout process they are granted an extra year until either the four one-year options run out or Telstra decides not to grant the one year option, at which point the five year phase of the contract kicks in.

Of paramount importance is the clause in the contract requiring Telstra to pay Vita an amount equal to the fair value of any store(s) should they decide to take the store(s) back at the end of the contract. While it is difficult to determine the value of these stores at an indeterminate time in the future, present industry estimates are for these stores to be valued at roughly 2-3 x EBITDA which, ironically, is roughly the multiple being assigned to Vita's entire telecommunications division by the current share price. As unlikely as it is this significantly reduces the negative impact of Telstra deciding to end the licensing arrangement with Vita since even a back of the envelope calculation reveals that any payout as a result of multiple stores being taken back by Telstra would be significant relative to the price that Vita shares are currently trading at.

For an investor in Vita it is worth taking the time to consider the possible outcomes of this agreement. With the contract applying on an individual store basis it is possible that Telstra could take back all, some or none of the stores operated by Vita. Should Telstra take back any of the stores Vita is contractually entitled to be compensated and as the earnings profile of each store improves, for reasons outlined in this report, the potential payout for these stores will increase in line with their value. The earliest possible stage that Telstra could take back *all* of their T-life stores would be 2018, since the last of the stores established in 2013 could see their contract come to an end.

While we cannot predict Telstra's future decisions we can reach logical conclusions from a combination of common sense and public information on Telstra's retail initiatives. It makes sense that Telstra made sure to implement the four one-year options before the five year agreement is initiated. While Vita have had a long standing relationship with Telstra, even prior to this specific contract being established, the fact remains that the store rollout process is the crucial phase of the contract. No doubt the telecommunications giant wanted to ensure Vita could meet their standards before committing to the full nine year length of the agreement. This is most likely the reason for an 'assessment' being conducted after each key phase of the store rollout prior to the extra year being granted to Vita. One would expect that once this phase of the contract is successfully progressed and provided the stores are performing well that Telstra would be willing to negotiate for contract extensions.

A contract extension or renegotiation that involves an increase in the length of time that Vita are granted the master license for T-life stores would be significantly value accretive for Vita. If this were to occur it would most likely be off the back of multiple years of strong performance by Vita in order to satisfy Telstra and justify an extension to the master licensing agreement. This would undoubtably be an optimal outcome for shareholders, but as an investor hoping for the best is not a valid investment thesis. Instead investors should reduce their risk by choosing a suitable valuation methodology, calculating a conservative estimate of Vita's value and paying a price that represents a significant discount to this value. In Vita's case the most conservative approach would be to value Vita by discounting the future cash flows from earnings and potential store buyback payments, assuming all T-life stores are closed by 2018. Of course, a logical evaluation of the circumstances would suggest that this outcome will not be the case but if investors can purchase Vita at a price substantially lower than the value determined from the method described they will reduce their risk of loss while leaving plenty of room for upside should a more favourable outcome eventuate. On this note it is worth pointing out that in the event that Telstra does decide to end the contracts with Vita the present value of the store buyback payments Vita would be entitled to receive ranges from $30m to $46m, depending on the timing of the contract expirations and the valuation applied to the stores.

Telstra's "Omni-channel" Strategy and Online Presence

Since David Thodey took charge Telstra have done a fantastic job of increasing the prominence of their online presence, which has been been transformed from a subpar website to what is now an easy to navigate online application allowing customers to pay bills, change their service subscriptions and make purchases, to name just a few. This has been driven by their Digital Director, Gerd Schenkel, who had success with UBank, an initiative he directed while at NAB. The development has been part of their "omni-channel" strategy - a fancy way of saying they plan to have physical and online stores well into the future, and intend for both to complement each other and enhance the customer's loyalty to Telstra services.

Telstra is in the business of "connecting people." They want to provide services to as many people as possible, all over Australia. To do this they need a presence in all areas, from the major cities to regional areas to the internet. Telstra owns many of the stores in major cities, Vita operate the majority of the regional stores and now Telstra have in place their online shop - together this represents the "omni-channel" strategy in action.

Telstra used the release of the iPhone 5 to increase awareness of their online store. They offered what was initially an online only deal of an extra 1GB of data/month for the first 12 months, valid until the 31st October. Some saw this as Telstra pushing their online store in favour of their physical stores, and while there is some truth to this the observation is not entirely correct. Firstly, the offer was marketed as being limited to online buyers when the only option to secure the iPhone 5 was to pre-order online, but the offer has since been extended to purchases made both online and in-person. Second, while Telstra's online sales were incredibly strong the number of phones sold in the pre-order period needs to be put in context. The handsets allocated to the online store were likely in the tens of thousands. Considering that in FY13 roughly 2.5m to 4m older iPhone's will come off contract, and can thus be reasonably assumed to upgrade to iPhone 5's, the number of phones sold online so far seems relatively small. And finally, the online stock has since been sold out and Telstra (as of this writing) are yet to re-stock. Delivery times are currently between 5-9 days so, at least over the short term, the online offering does not appear particularly attractive. Of course, one would expect Telstra to improve the service provided to their online customers in time.

While the impact of online sales of mobile phones is relatively new to the Australian market the success of online stores in other retail sectors and in similar markets overseas suggests Telstra's online store will see strong sales growth as time goes by. It can be argued that Telstra's online strategy represents more of a threat to Vita's Telstra stores than do the retail stores of the likes of Optus and Vodafone - testament to Telstra's strong market-leading position - and it therefore requires a closer analysis.

Telstra have made public their objective of seeing 35% of sales conducted online by 2013. However, it is important to understand that this figure takes into account all of the services provided by Telstra, rather than just mobile phone sales, and therefore likely overstates the impact on Vita since tasks like paying bills and downloading movies are always going to be more suitable to online applications. As a result this figure suggests that on Telstra's own estimates we can expect sales of mobile phones online to be somewhere below 35% in FY13. But we cannot rely on guess work and assumptions when investing. In order to comprehend the likely impact of online sales on Telstra and Fone Zone stores we need to turn to hard evidence, which can be found in studies and reports on mobile phone markets overseas.

A study on the European mobile phone market in 2010 by Gfk Retail and Technology found that just over 7% of mobile phones were sold online, which was a 10% increase over the previous year. Of the total pool of mobile phone sales 70% were purchased from specialist service providers, akin to Telstra and it's competitors. Interestingly the study found that smart phones were more likely to be sold online, with the figure reaching 20% for that sub-category. A Nielsen study released in February 2012 showed that 50% of mobile phones in the US are smartphones, while 66% of phones purchased in the 12 months prior were smartphones, suggesting that figure will to continue to grow strongly.

A study on the Polish mobile phone market in 2011 also found that 20% of contract applications are submitted online. Of those who chose to purchase online convenience, free delivery and a lower handset price were key drivers while in the four out of five consumers who purchased offline face-to-face contact was highly valued, as was the offer of a faster transaction i.e purchasing the phone and having it ready to go on the spot.

A study released in 2011, again by GFK Retail and Technology, found that 17% of consumer electronics were purchased online in 2010. While it did not reveal specific statistics regarding online smartphone sales the fact that the headline figure is in close proximity to what was found in other markets suggests the numbers are likely quite similar.

A report titled *E-commerce and Consumer Electronics: Online Shopping & Purchasing* examined the purchasing decisions of US consumers who bought a smartphone in 2011. The report found that while 52% of consumers research and compare phones online prior to making a purchase only 23% could imagine themselves actually going through with the transaction over the internet while the majority preferred to go in store to buy. This is supportive of the theory that the purchase of a smartphone is a service-heavy transaction, resulting in the preference of customers to purchase from a physical store.

A study by Market Force Information released in January of this year compared the purchase of consumer electronics through bricks and mortar stores and online, and what factors drove the decisions made by consumers. Of those surveyed all had purchased an electronic device from a retail store over the 2011 holiday period, but only 35% had done so online. The authors concluded that the nature of some consumer electronics means that the sales agent plays an important role in the transaction. They added "We discovered that the human factor in the retail process is incredibly powerful when consumer electronics are concerned...Not only do shoppers value and trust the opinions of electronics salespeople, they also tend to follow their advice, which tells us this role carries more weight than in other industries." This is powerful information considering the immense popularity of Amazon and other highly efficient online retailers in the US.

While comparisons between the Australian market and overseas markets are useful it is important to acknowledge the number of fundamental differences across markets that will likely result in varying proportions of smartphones being sold online. One example can be seen in the US market where the subsidies applied to handsets are typically much smaller than what the Australian service providers offer. For example in the US Verizon Wireless will subsidise the iPhone 5 to the point where the consumer must pay $199 (16GB), $299

(32GB) or $399 (64GB) which represents between 33% and 50% of what Verizon pays to purchase the phone off Apple. In contrast, in Australia we pay nothing up front on $0 plans, with the price being built in to the contract. What this means is that US consumers are more likely to shop online for better prices, which the service providers can offer them through their online stores due to lower overheads. A study by 'ThinkTech with Google' found that the number one reason US consumers chose to purchase a smartphone online was cheaper prices, and when one understands what those consumers must pay for an iPhone this is entirely understandable. But that dynamic does not exist to the same extent in Australia, meaning Australian consumers are less likely to price compare between online and in store but rather between service providers. Similarly, according to a study by Price Waterhouse Coopers and Frost & Sullivan, 55% of consumers choose to shop online because of cheaper prices, something that is not available for smartphones when comparing in store and online offers.

The transition of mobile phone sales online in Australia will initially be sudden, due to pent up demand, then gradual as it reaches a stable percentage of total sales. If we assume that in FY13 the Australian mobile market went immediately to 30% of sales occurring online then the impact to Vita's telecommunications division would result in total earnings falling by 17%. (This assumes all sales in telecommunications are negatively impacted to the tune of 30%. Remember that not all of Vita's telecommunications revenues are from mobile phone sales). In this scenario the 17% drop would need to be made up by a combination of new stores, existing stores maturing, new product releases and a wave of contract expirations. With Telstra store numbers expected to rise by roughly 20% from the end of FY12 to the completion of the store rollout process total sales should increase strongly, and the conditions present in FY13 should result in strong like for like sales growth, suggesting that even in the scenario of a dramatic jump in online sales to an extent greater than that seen in comparable markets overseas, that Vita's total sales growth should still grow strongly in FY13 and in the years to come.

Investors need to be aware of Telstra's retail strategy and how their online and physical stores will complement each other going forward. Some sales will most certainly move online but precedent suggests that going in-store to buy a phone will remain the most popular option. While consumers will conduct their research online Vita's service offering will play an important role in driving customers to visit their stores in favour of completing the purchase over the internet. Selling associated accessories and new services like Liquipel will help to support margins as well as differentiate their offering from what is available from online competitors. Increased competition between Samsung, Apple and other handset developers will encourage consumers to purchase in store where comparisons can be made between products before making a decision. As the product cycle continues and new technologies are developed we can continue to expect sales to come in waves, in line with the mass expiration of contracts. In conjunction with the increased store presence of Vita's Telstra and Next Byte stores we should see strong sales growth over the next few years, regardless of the impact that the online store has on the mobile phone market. The online sale of mobile phones is here to stay but the reports of physical stores being sold out of iPhone 5's in markets across the world, often in areas like the US where online sales are more prominent than in Australia, suggests consumers will continue to purchase mobile phones in traditional stores for some time to come.

Key Risks

Like any investment, Vita Group carries risks. The main risks of an investment in Vita Group include, but are not limited to, the following:

- While undoubtedly a strength of Vita's, the relationship with Telstra and Apple put them at the whim of these two companies, as was mentioned earlier in the discussion on margins. An example of this occurred in 2006 when Telstra released its Next G Network on a smaller range of handsets than expected and on less profitable models, which reduced Vita's margins. On balance the relationship with both Telstra and Vita will be an entirely positive one but the extent to which Vita is reliant on decisions by their two key partners needs to be taken into consideration.
- While Telstra stands as the dominant player in mobile phones today a lot can change in a short span of time. Just as a large number of contracts expiring in FY13 is an opportunity for Vita, it is also a risk if consumers, for whatever reason, choose Optus, Vodafone or Virgin over Telstra. No doubt Telstra's competitors will be pushing hard to regain lost ground, aware that many will come off contract in the coming months, and will be more than willing to compete on price and service quality.
- A quick look at the balance sheet will draw your attention to the jump in trade and other payables, which was the reason for the increase in current liabilities. The difference is exaggerated by $12m of unearned revenue and the $3.5m increase in other payables and accruals, the latter of which includes such things as rental obligations and liabilities for wages and salaries. These liabilities should be funded by future cash flows as payments come through at point of sale, particularly if revenue begins to pick up in the current half due to product releases and the expiration of old contracts. The payment terms for Vita's customers and suppliers, detailed earlier, explains the reason for the working capital deficit and should eventually prove self correcting as capital expenditures decline. Management describe the rise in payables as "normal" and it does appear to simply be a timing issue that shouldn't create any cause for concern. The situation only really becomes a risk if sales fall below expectations or cash flows become tight. As a result it is something investors need not be overly concerned about but should keep an eye on regardless.
- Vita are involved in a number of entrepreneurially spirited start up ventures such as Sprout (mobile phone accessories), iConcierge, Twelp Tribe (twitter based help service) and Finga (an application developed to help streamline and manage small businesses). Sprout began in September 2011 and broke even in 2012. Sprout accessories will feed in to Vita's retail presence and should fit in well with the company's current line of business. iConcierge and Twelp Tribe compliment Vita's focus on customer service and satisfaction while Finga is a result of the company's intentions to increase their focus on the small business customer. While all of these initiatives are relatively low cost and appear to be operating in markets in which there is strong demand any potential investor should be aware of the inevitable risks that surround start ups and new ideas.
- More so than would be the case for a company that possesses a demonstrated track record of earnings the situation for Vita at present means that the value of this company is largely based on forward projections. If correct then the returns will surely justify the risk but by its very nature any investment in Vita exposes you to the risk that your analysis is wrong or that the company fails to pull through on one or more of the key factors integral in your assessment of Vita's future performance. Because of this it could be argued that any investment in Vita requires substantially more research than what would be required of a 'simpler' investment. The only way to reduce your risk is to better understand the company and it is important you dedicate a considerable amount of time and effort to doing so.

FY12 Financials And Outlook

Despite the reported loss in FY12 the Vita balance sheet remains healthy and should be further strengthened by the expected increase in sales in FY13. The Next Byte impairment was a necessary evil and at a lower carrying value it better reflects the earnings potential of the business and sets the company up to generate higher returns on equity in the future.

The rollout of the Telstra stores has been funded by the entitlement payments from Telstra, operating cash flows and bank debt. Debt levels remain in safe territory with net debt of just $9.7m and gearing at 20.7%. Interest expense increased in FY12 as gross debt levels increased but management have forecast for debt to peak in the first half of FY13 as the store rollout nears completion, with expectations for net debt to rise to $12-$15m before falling back to current levels by the end of calendar 2012. While cash flow is currently sufficient to cover Vita's operating and investing requirements investors should be aware that capital management during an expansion process is a balancing act and they are reliant on management continuing to execute effectively.

Capital expenditures for FY13 should fall in the range of $11-$14m, with depreciation also reaching its peak in the current financial year. This is key to the company's improving profitability since more stores reaching maturity should equate to higher profitability and greater returns being provided for shareholders.

Despite experiencing a period of rapid expansion Vita will pay a fully franked dividend of 1.5c for FY12, which management have explicitly stated is a signal of their confidence in the future profitability of the business. As mentioned the capital available for dividends should expand in FY13 and FY14 with the target payout ratio of the company standing at 65% of earnings.

Later in the half management will likely release their forecast for FY13 and perhaps give guidance for FY14. Using what I consider to be very conservative figures my expectations for NPAT in FY13 is $6.5m-$7m, which assumes 9% total revenue growth over the previous period and takes into account management's forecasts for debt levels, depreciation and capital expenditure. While I would not be at all surprised to see this figure surpassed, perhaps substantially, due to reasons outlined in this report, I prefer to remain conservative and use this range in my calculations of the company's current value. This figure would equate to EPS of around 4.8c for FY13 with expectations for substantial improvements in FY14 and returns on equity in excess of 20%.

The nature of Vita's earnings calls for a valuation using a discounted cash flow (DCF) approach. In doing this an investor can vary his or her inputs depending on the outcomes they expect regarding both future earnings and any store payments from Telstra as contracts expire. From the information provided each investor will have their own views as to the most likely outcomes for Vita, so an independent valuation is required and any investor purchasing shares in Vita should have their own estimation of the value of this company. That said, assuming no extension to the master license agreement with Telstra my DCF valuation for Vita Group is 60c, while a more optimistic and arguably more likely outcome produces a valuation significantly higher. I know of fund managers much smarter than I am with DCF valuations for Vita in the high 80c range and while any valuation merely represents an estimate it is comforting to find agreement with smart investors. It is easy to become too focused on the details regarding valuations and for most investors a wise approach would be to look for signs of obvious value in order to minimise the risk that your estimations turn out to be off the mark. Using such an approach if the forecasts for earnings and the expectations of growth prove to be accurate it appears there is substantial value on offer for those willing to take a closer look at this hidden growth story.

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