IOOF Holdings 02/02/2012 **FAT-AUS-560**

IFL AUD $5.65 Spec. **MED.** **B**

A levered play on financial markets

IOOF is one of the largest independent financial service companies in Australia. We view the recent weakness in the company's stock price to represent an attractive investment opportunity for those investors with a 12-month or longer view. The stock has a handy 7.5% dividend yield and is trading around 13x June 2012 earnings estimates, which we consider to be depressed, thus providing the opportunity for a substantial rebound in the stock price over time.

As a wealth management stock, the company's fortunes are closely linked to the state of affairs in global equity markets. When financial markets are weak or especially turbulent, many investors are cautious and withdraw funds or sit on the sidelines waiting for times to improve before allocating more capital into financial products.

In the case of IOOF, this was evident in the decrease in Funds Under Management and Administration, Advice and Supervision (FUMAS) from $106 billion as of June 30, 2011 to around $100 billion as of September 30, 2011. Since then the company completed an acquisition of DKN Financial Group that strengthened their financial adviser network and added around $18 billion in FUMAS.

IOOF has one of the lowest cost profiles amongst its peers with a cost-to-income ratio of just 51% in the 2011 financial year. The company also generates plenty of cash, with $144 million of pre-tax operating cash flow in 2011. This leaves them well positioned to cope with weaker markets while retaining operating leverage to markets when they strengthen and flows of capital return.

While we cannot be sure when this will occur, it is likely the stock will move quickly to the upside when it does or before. Hence, we consider the current entry point for the stock to represent a good risk to reward proposal. While the stock may languish for a while if markets do not see a resolution to the European debt mess, we see the downside as much more limited than the upside at this price.

We also believe the company's vertically integrated business model better positions them to deal with future regulatory changes that may occur. The company would also benefit from an increase in superannuation contributions from 9-12% that has been recently proposed by the government.

The recent break above the 50 day moving average at $5.48 is suggestive of momentum to favour the upside. The next upside target is towards the confluence of resistance, made up of the December 2011 high and 200 day moving average of $5.96. The RSI continues to strengthen, which is indicative of higher levels to come over the coming months.

The frugal one

While incorporated as a Friendly Society in 1846, the modern era for the company began with its listing on the ASX in 2003. The company has changed significantly since then with growth in recent years driven by mergers and acquisitions activity.

Two key transactions were the merger with Australian Wealth Management (AWM) and the acquisition of Skandia. AWM's key assets were Spectrum Super, Wealth Managers and a 70% stake in Ord Minnett. Skandia was a platform administration business focusing on long-term savings products such as managed investment and superannuation products.

The company also recently acquired DKN Financial Group (discussed below). We believe the company is likely to continue with this model of M&A and gobbling up smaller players and its management has proved themselves adept at extracting cost synergies.

We estimate that net debt following the DKN acquisition would only be around $40 million, a modest amount for a company generating circa $140 million in operating cash flow. Thus, they could resume their acquisition strategy as early as this year. An alternative is that they have grown to a size that would be interesting for the larger players in the industry to absorb.

IOOF has proved itself a master of frugality taking significant costs out of the integrated businesses and has one of the leanest cost profiles in the industry. Besides general cost synergies from integrations, the company has rationalized the number of legacy systems it has in place.

We like management's approach; they tend to be conservative but effective. CEO Chris Kelaher took the reins following the merger with AWM in 2009.

Business overview

We now want to take a closer look at the company's underlying business. The company provides a range of services through four distinct divisions under a number of different brands: platform management and administration, investment management, financial advice and distribution and trustee and estate services.

The important thing for investors to remember is that the fortune of stocks such as IOOF is positively correlated with general financial markets. Revenue will grow or shrink with the change in market valuations on average FUMAS from one reporting period to the next. The number of investors in the company's products also tends increase in good times and drop off during challenging financial markets.

Platform Management and Administration

The Platform Management and Administration division generates the lion's share of profit for the company, around 60% in the 2011 financial year. The platforms allow both retail and corporate clients to manage a range of superannuation and investment options such as managed funds and direct shares. The flagship platforms for the group include Spectrum Super, Pursuit and The Portfolio Service.

Investment Management

The group's Investment Management division includes Perennial Investment Partners, IOOF Multimix and Wealth Builder. This is the second largest contributor to the group's profit, chipping in around 30% in 2011. These companies provide a range of investment options across different asset classes. Perennial, for example, provides investors access to Australian shares, international shares, Australian listed property, global listed property, fixed interest products.

Financial Advice and Distribution

IOOF recently boosted its heft in this division with the acquisition of DKN Financial Group, whose acquisition was completed in October 2011. This boosted the number of financial advisers under the IOOF umbrella from 650 to around 1,000 and added $18 billion to the $100 billion the company has in FUMAS. We believe there is an opportunity to gain some cost synergies with the deal as IOOF has successfully integrated a number of other acquisitions.

In 2011, this division made up around 6% of the groups profits. The major brands in the IOOF portfolio in this division include Bridges, Ord Minnett (70% ownership), Consultum, Lonsdale and Wealth Managers.

Trustee and Estate Services

Trustee services including estate planning and corporate trust services. This includes such services as preparing estate plans, wills, powers of attorney, personal trusts and managing deceased estates on behalf of clients. The company Australian Executor Trustees (AET) represents IOOF in this area and also acts as a custodian and trustee for managed investment schemes, structured finance transactions and debt issues. This division was responsible for around 4% of 2011 profit.

With reference to the weekly chart, a sustained break of the 39 and 200 week moving average at the $6.00 region, would spark a longer term move towards the psychological $7.00 /8.00 vicinity.

Summary

There are a number of things we find appealing in IOOF - its operating leverage to an improvement in financial markets, lean cost profile, potential for M&A and a vertically integrated business model that stands it in good stead to deal with any regulatory changes. With the stock trading below its historical average on cyclically depressed earnings, there is scope for earnings growth and earnings multiple expansion and an investor is rewarded with a handy 7.5% dividend yield.

The company would also get a shot in the arm from an increase in superannuation contributions from 9% to 12% that has been recently proposed by the government if it was to go through.

Therefore, we recommend IOOF as a buy to members around current levels.

Snapshot IFL

IOOF Holdings

Latest Closing Price: $5.65

IOOF Holdings Ltd, along with its subsidiaries is engaged in providing financial advice and distribution; platform management and superannuation administration; investment management, and trustee services including estate planning and corporate trust. It operates in five segments: platform management and administration, which is engaged in the provision of administration and management services; investment management, which is engaged in the management and investment of monies on behalf of corporate, superannuation, institutional clients and private individual investor clients; financial advice and distribution, which is engaged in the provision of financial planning advice; estate and trustee services.

Market Capitalisation:$1.3bn

	FY1	FY2
Price to Earnings	13.2	12.2
Dividend Yield (%)	7.5	7.8
Price to Book	1.5	1.5
Return on Equity (%)	11.2	12.0