

MFG

AUD \$1.740

Core

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Navigating its way up the performance tables!

Of all the listed Australian fund managers, this one in our view has the best pedigree of the lot. Magellan is a boutique funds management business that caters to high net worth individuals and retail investors alike. It also manages wholesale or institutional mandates.



One of the key differentiators of the business model is that it is specialised in managing a global mandate – this lies in contrast to the majority of Australian listed fund managers that are Australian equities centric.

The two principals and founders of the business are Chris Mackay and Hamish Douglass. They both come with impressive credentials. Chris Mackay is a lawyer and investment banker and was formerly chairman and CEO of UBS Australasia. Hamish Douglass was co-head of global banking at Deutsche Bank in Australia and NZ. Extensive experience in merger and acquisition activity and corporate advisory work has allowed

them to build up an impressive team under their leadership, which has to date delivered a top rated performance across their range of funds.

Fund Under Management

| Funds Management (\$m) | | | | | | | |
|------------------------|----------------|----------------|----------------|----------------|----------------|----------------|----------------|
| | Aug-11 | Sep-11 | Oct-11 | Nov-11 | Dec-11 | Jan-12 | Feb-12 |
| Retail | \$1,108 | \$1,174 | \$1,194 | \$1,318 | \$1,406 | \$1,403 | \$1,530 |
| Wholesale | \$1,517 | \$1,577 | \$1,473 | \$1,496 | \$1,527 | \$1,508 | \$1,540 |
| Total | \$2,625 | \$2,751 | \$2,666 | \$2,814 | \$2,933 | \$2,911 | \$3,070 |

Funds under management have grown 16 percent to around \$3 billion over the past 6 months. This is impressive considering many funds management businesses have experienced net outflows in FUM during this period.

Funds and Performance

Briefly, there are three global investment funds;

- a) Magellan Global Fund – long only unlisted unit trust that invests in a concentrated portfolio of global equities. The focus of this fund is on multinational consumer franchises, but ones that “have a very significant proportion of their current earnings coming out of the major emerging markets”.
- b) Magellan Infrastructure Fund – long only absolute return global infrastructure securities focused portfolio
- c) Magellan Flagship Fund – this is a listed investment company of high quality global equities.

One of the key drivers of their growth has been performance. As illustrated by the tables below.

| MAGELLAN INFRASTRUCTURE | 1 Year | 2 Year | 3 Year | 4 Year | 5 Year |
|--------------------------------|--------------|--------------|---------------|--------------|--------------|
| | | (%pa) | (%pa) | (%pa) | (%pa) |
| Magellan Infrastructure | 7.83% | 15.62% | 23.72% | 2.32% | 1.34% |
| Benchmark | 1.25% | 7.85% | 12.54% | -0.39% | -0.98% |
| Excess Return | 6.58% | 7.77% | 11.18% | 2.71% | 2.32% |

| MAGELLAN GLOBAL FUND | 1 Year | 2 Year | 3 Year | 4 Year | Inception |
|-----------------------------|--------|--------|--------|--------|-----------|
| | | (%pa) | (%pa) | (%pa) | (%pa) |
| Magellan Global Fund | 7.99% | 6.62% | 8.66% | 6.21% | 2.63% |

| | | | | | |
|-------------------------------------|--------|-------|-------|--------|-------|
| Excess return relative to Benchmark | 15.34% | 7.05% | 5.70% | 10.33% | 9.91% |
|-------------------------------------|--------|-------|-------|--------|-------|

Having a specialist infrastructure fund has been very beneficial as the demand for low beta (correlation to the market), high yield, type assets has been very robust given the volatility and risk aversion that has pervaded equity markets in recent times. These kinds of returns led to the Magellan Global Fund to be deemed by Mercer the 'best of its kind in the world' in 2009. The outperformance has led to some material performance fees. In the December half year, \$4.7m was earned in performance fees or perhaps more appropriately 'out-performance fees'

Leveraged Play on Equity Markets

We regard Magellan to be a high quality leveraged play on equity markets, on three different levels.

Ongoing growth in FUM at Magellan is likely to remain positively correlated with the direction of the stock market. As markets rise, funds under management also rise organically and hence this directly benefits the revenue line as fees rise on an increasing base.

Magellan also has more direct exposure to equity markets - the company's balance sheet has no debt and has a large component of 'financial assets' at approximately \$84 million. This is MFG's own capital that is invested in its equity funds. Hence should equity markets rise so will the company's own Net Tangible Assets (NTA).

Lastly, should their funds continue to out-perform their respective benchmarks MFG will attract more funds inflow in addition to performance fees. Hence, the leverage is potentially threefold.



The charting picture is also encouraging. After completing a double bottom pattern in July/September 2011 at the \$1.14 region, prices have rebounded sharply higher. In addition, the bullish moving average cross in place, adds fuel to the bull rotation seen over the past months. In the near term, we would expect a retest of the February highs of \$1.85.

With reference to the weekly chart, prices are testing the 78.6% Fibonacci retracement. A weekly close above this level, would activate the next broader term upside target towards the \$2.20 region (127.2% Fibonacci extension).

Valuation

MFG's market capitalisation is approximately \$300m currently. If we 'strip out' the NTA from the balance sheet which is approximately \$130m, we are left with \$170m, being the difference between the two. That is essentially the value the market is attributing to the funds management business.

As a percentage of FUM this number is approximately 5%. The rule of thumb we tend to follow is broadly that fair value is typically 6% of retail FUM. Retail margins are higher than the margin on wholesale FUM and typically a lot more 'sticky'. When we adjust (lower) the number to allow for the fact that half of the \$3bn in funds are wholesale mandates we estimate a ratio of approximately 7%.

What is key here is the GROWTH RATE of FUM. It has been spectacular, from January 2010 MFG had \$700m in funds under management and this now sits at \$3bn. The most likely scenario in our view is it will continue to grow at a very healthy clip but perhaps not at levels as we have seen to date.

When overlaying a conservative DCF valuation which is based on modest organic long term growth in funds in addition to conservative net inflows we estimate a valuation for MFG at around \$2.10 per share. We have also assumed ZERO performance fees into perpetuity which is highly unlikely! Especially given the out-performance illustrated in the above table.

Overall, our assessment is that we are buying growth at a very reasonable price. We believe that the people, the process and the performance will continue to translate into FUM growth. **We have assumed only a fraction of the of the current growth rate in our DCF valuation.** With a supportive equity market as demand for risk assets improves, we see continued outperformance in the MFG share price driven by the threefold leverage we alluded to earlier.

One important caveat is that whilst the leverage in this business works fabulously on the way up, this also works the same way on the way down and hence we rate this stock as HIGH risk.

Finally, given the lack of liquidity in the stock, we recommend members be patient in acquiring the stock at around current levels. **We recommend Magellan as a buy to all Members around \$1.75.**

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Snapshot MFG

Magellan Financial Group

Latest Closing Price: \$1.74

Magellan Financial Group Limited (Magellan) is an Australia-based company. The principal business activity of Magellan is funds management with the objective to offer international investment funds to retail investors in Australia and New Zealand, and institutional investors. The Company operates in three segments: Funds Management, Principal Investments and Unallocated-

Corporate. Funds management activities are undertaken by the controlled entity, Magellan Asset Management Limited (MAM). The principal investment portfolio is consists of investments in the Magellan Flagship Fund Limited (the Flagship Fund), the Magellan Infrastructure Fund (Unlisted Funds), and in a select portfolio of Australian and international listed companies, cash and fixed interest securities and other investments. Magellan Asset Management Limited is the Company's wholly owned subsidiary.

Market Capitalisation:\$300m

| | FY1 | FY2 |
|-------------------|------|-----|
| Price to Earnings | 30.6 | |

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