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# Firstfolio Limited (FFF)

A bank in everything but name

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## Recommendation

**Buy**

### Price

**\$0.062**

**Target (12 months)**

**\$0.120**

We initiate coverage on FFF with a \$0.12 price target. The company is a mortgage manager and aggregator and is fast becoming the preferred strategic partner of mainstream banks. As a result of recent acquisitions and synergies, we expect ROE to trend above 20% in the medium term. Our Buy rating is also supported by FFF's value creating potential as an active consolidator and a target for larger players.

## Expected Return

Capital growth **93.5%**

Dividend yield **0.0%**

Total expected return **93.5%**

## Company Data & Ratios

Enterprise value **\$59m**

Market cap **\$45m**

Issued capital **729m**

Free float **74.6%**

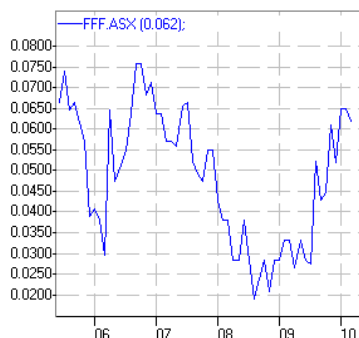
12 month price range  
**\$0.024 - \$0.070**

GICS sector

### Diversified Financials

Disclosure: SCE acted as underwriter/lead manager of a 1:2 rights issue to raise \$12.1m in December 2009 and received a fee.

### Absolute Price



SOURCE: IRESS

## Specialist mortgage banking platform

We believe FFF is a mortgage bank in everything but name, uniquely positioned to capitalise on the strong outlook for financial services but without the usual risks/constraints. While it makes money from margins, these are service-oriented and more a function of the company's relative efficiencies. Value drivers include the ability to utilise its distribution platform (with sufficient capacity for future expansion) to extract economies of scale from additional loan acquisitions, sustained earnings growth from increasing footprints in QLD, VIC and WA, licensing opportunities to replicate e-Choice in Asia, and capital efficiencies leading to 20%+ ROE in the medium term.

## Significant value both as a consolidator and target

The \$0.12 price target (14.0 times 2010e earnings and 8.2 times 2010e EBITDA, down to 10.4 times and 4.6 times respectively in 2012e) reflects FFF's stellar growth and ROE potential. At current prices, FFF represents an inexpensive entry point into low risk/capital efficient virtual mortgage banking. The lower multiples ignore the company's strategic appeal and role as an active consolidator in the mortgage management/aggregation market space (with further accretive acquisitions currently on offer).

### Earnings Forecast

Year end 30 June	2009	2010e	2011e	2012e
EBITDA (A\$m)	5.4	10.6	15.3	18.9
NPAT (statutory) (A\$m)	3.3	5.3	7.2	8.8
EPS (statutory) (cps)	0.8	0.9	0.9	1.2
EPS growth (%)	n/m	9%	10%	22%
PER (x)	7.9	7.2	6.6	5.4
P/EBITDA (x)	8.4	4.3	3.0	2.4
EV/EBITDA (x)	11.0	5.6	3.9	3.1
Dividend (¢ps)	0.0	0.0	0.0	0.0
Yield (%)	0%	0%	0%	0%
ROE (%)	36%	19%	21%	21%

SOURCE: SOUTHERN CROSS EQUITIES ESTIMATES

# Mortgage banking model of the future

**Australia's largest independent distribution platform**

## Banks' emerging strategic partner

We initiate coverage on Firstfolio Limited (FFF) with a strong Buy rating and a price target of \$0.12 per share. FFF is currently Australia's largest independent national aggregator and distribution platform for the delivery of financial products and services (mainly mortgages).

FFF's operations are supported by 80 staff (Sydney, Melbourne and Brisbane), an online channel and a physical footprint of over 400 active brokers, 80 tied loan writers and over 500 referring members (legal, accounting, financial planning and real estate professionals) across the country. The strongest representation is in NSW (55%), followed by QLD (20%) and VIC (15%) (Figure 1).

Figure 1 – FFF leveraged to the network effect



SOURCE: COMPANY DATA

**Funders include the majors, specialist lenders, ING and Adelaide Bank**

Funding lines are largely provided by the majors, specialist lenders, ING and Adelaide Bank. We understand lending constraints have eased at this time. Current Loans under Management (LUM) are estimated at \$18bn (more than 60,000 borrowers), significantly boosted by the acquisitions of mortgage managers Loans Services Australia and First Chartered Capital in December 2009. In line with its 2004 Go Forward Strategy, the company has successfully transformed itself into an IT-enabled lending solutions/mortgage specialist.

Figure 2 – E2E distribution model



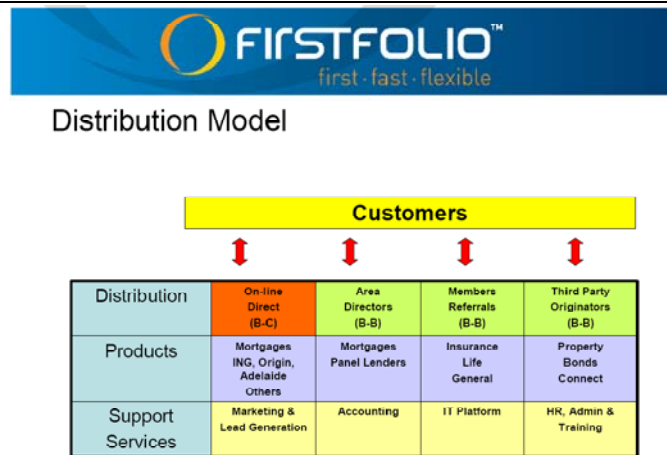
SOURCE: COMPANY DATA

**Competency in managing the full loan transaction life cycle**

This is based on its core competency in managing the full loan transaction life cycle, spanning: lead generation; processing; verification; settlement; and ongoing management of the loan (Figure 2). The value proposition to clients (e.g. individual mortgage brokers, broker groups and independent businesses providing branded lending solutions) revolves around a strong back office platform, growing distribution network, flexibility (as compared with traditional lenders) and consistency and speed of service (Figure 3).

While FFF’s core activities are traditionally mortgage processing/management including the provision of wholesale funds from leading financial institutions, it has recently moved into the higher margin direct distribution business (through its e-Choice and New-Loan brands) with much greater pricing flexibility and control over the borrowers (see next section).

Figure 3 – Customer-centric model



SOURCE: COMPANY DATA

**Cherry-picking across the mortgage value chain**

FFF has three core businesses (Figure 4) and these are described below.

**WHOLESALE**

**Wholesale business generates stable cash flows**

Trading under the **Firstfolio Wholesale** brand, clients are largely sub-originators (who brand their own products through a white label arrangement). LUM is around \$5bn with funding sourced from major institutions including ING and Adelaide Bank. In addition to funding, FFF’s Wholesale business provides services such as in-house delegated authority and access to an online platform for full transparency throughout the home loan value chain. The main competitors include FirstMac (around \$7bn LUM funded largely from the RMBS market and with its own IT platform) and RESIMAC (\$11bn LUM and supported by Perpetual, BNY Mellon, NAB, Deutsche and Barclays).

The value drivers include upfront (including processing fees) and trail revenues net of commissions paid to brokers. The upfront revenue is based on settlements while the trail revenue (expected over 10 years) is based on LUM outstanding. Commissions payable to brokers are based on settlements. The value drivers of this business are found in Table 1.

**DIRECT TO MARKET**

Trading under FFF’s virtual platform **e-Choice**, the clients are retail consumers sourcing products from a multi-supplier panel. LUM is estimated at over \$3bn with funding sourced from 20+ panel lenders including all the majors, specialist lenders, ING and Adelaide Bank. Competition largely comes from Mortgage

**Direct business is high margin with strong growth potential**

**Aggregation business makes up for lower margins with higher volumes**

Choice (\$37bn LUM) and Aussie (\$34bn LUM).

The value drivers in the e-Choice business are similar to the Wholesale business and include upfront and trail revenues net of commissions paid to brokers. Our assumptions are found in Table 1. We estimate the operating margin in the e-Choice business is nearly double that of the Wholesale business.

While categorised as a Wholesale business in Figure 4, we feel the **New-Loan** brand has more in common with e-Choice with its direct offerings to retail consumers (and brokers). LUM is estimated at \$250m with funding sourced from ING and Adelaide Bank. FFF’s main competitors in this space include Aussie (\$34bn LUM) and RAMS (\$10bn LUM).

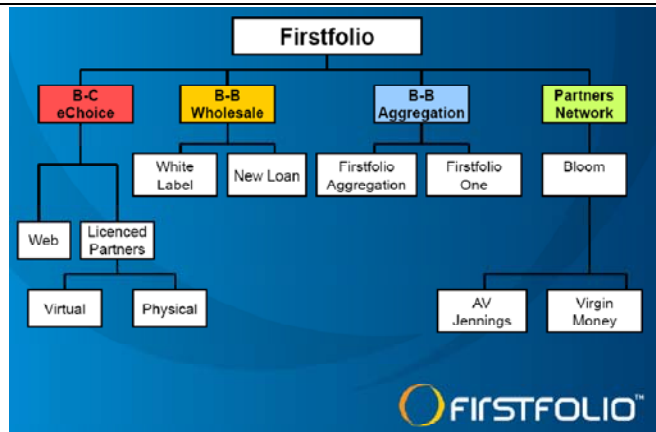
The value drivers in the New-Loan business include upfront and trail revenues net of commissions paid to brokers plus a processing cost (Table 1). We estimate the operating margin is 1.5 times that of the Wholesale business.

**AGGREGATION**

The clients of Firstfolio Aggregation and Firstfolio One are brokers. LUM is just over \$12bn with funding again sourced from 20+ panel lenders including all the majors, specialist lenders, ING and Adelaide Bank. FFF’s main competitors are industry leader AFG (2,500+ members and \$50bn LUM) and NAB’s PLAN/Choice brands (\$4.5bn LUM – acquired from CGF). The value drivers are found in Table 1.

We estimate Aggregation has the lowest operating margin of the core businesses (at a quarter of the Wholesale business margin) despite comprising nearly 60% of LUM. As a result, we are not surprised with FFF’s push into the Wholesale and Direct to Market segments with their higher margins and better control of the customer relationships.

**Figure 4 – Three core businesses plus an alliance network**



SOURCE: COMPANY DATA

**Table 1 – Key assumptions of core activities**

Value drivers	Wholesale	Direct to Market		Aggregation
		e-Choice	New-Loan	
Upfront revenue (bp)	125-130	60-65	150-155	60-65
Trail revenue (10 years) (bp)	13	15	25	15
Commissions payable to brokers (bp)	115	30	40	55
Processing costs (bp)	-	-	25	-
Loan settlements per month (\$m)	120-125	65-70	120-125	225-230
Settlement / redemptions (times)	15	1.5	2.0	1.5

SOURCE: SOUTHERN CROSS EQUITIES ESTIMATES

**Bloom further strengthens lead generating capacity**

FFF has a fourth business called **Partners Network** that centres on Bloom, a proprietary B2B software application. The latest partner to join Bloom is Medibank Private with its 3.5m members. A 12 month service agreement means Medibank's members will have access to the eChoice portal including discounts on all major bank loans and a simplified home loan fee.

The Bloom platform is designed as a bolt on application that FFF partners integrate into their own IT systems to provide tailored lending solutions to their own customers and to explore new business opportunities. Other partners include AV Jennings and Virgin Money. Bloom is capable of tracking spending patterns as part of a broader segmentation strategy, the centre point of FFF's customer-centric relationship management.

**Low risk, capital efficient investment proposition**
**Buying a 'Bank' without the usual banking risks**

We believe FFF is a mortgage bank in everything but name. The company is uniquely positioned to capitalise on the strong outlook for financial services but without the usual credit/operating risks and capital constraints. While it makes money from the traditional 'haircut' business, the margins extracted appear more service-oriented and are a function of the company's relative efficiencies.

FFF's strategy revolves around the following competencies:

1. Partnership-based business model that facilitates rapid geographic expansion without heavy capital expenditure;
2. Strong relationships with clients;
3. Lead generation and management using direct sales experience; and
4. Innovative product and service offering.

FFF's value drivers include the ability to utilise its seasoned financial services distribution platform (with sufficient capacity for future expansion) to extract economies of scale from additional LUM acquisitions, sustain earnings growth from increasing footprints in QLD, VIC and WA, and leverage on capital efficiencies leading to 20%+ ROE in the medium term.

**LEVERAGED TO THE NETWORK EFFECT**
**Strong form network effect**

FFF's business is created around distribution and its IT-enabled strategy is believed to be the key to harnessing the power of the wider financial services marketplace through the network effect (and thus sustaining growth). We first explored Metcalfe's Law<sup>1</sup> in 2006 (while assessing a process-oriented company) and believe this is highly relevant to FFF. The law states that the value of a network increases exponentially by the number of connected users and is commonly represented by the following equation:

$$\text{Value} = \text{number of users} \times (\text{number of users} - 1) / 2$$

Referring to Figure 1, we feel FFF has a strong form of network effect. This is underpinned by improving liquidity (i.e. funding) and sector consolidation concentrating market share into the hands of a few players. With the company now the largest independent national distribution platform and with core competencies as described above, we feel it is even more compelling for new

<sup>1</sup> Gilder, G. George Gilder's Telecosm: Metcalfe's Law and Legacy. *Forbes* ASAP, September 13, 1993. Gilder coined 'Metcalfe's Law' that was named after Robert Metcalfe, founder of the Ethernet and 3Com.

**Market adjacencies to add extra value**

**“Achieving more by doing less”**

brokers and lenders to join in – to further increase the collective value of FFF’s network (i.e. the more users, the lower the adoption threshold).

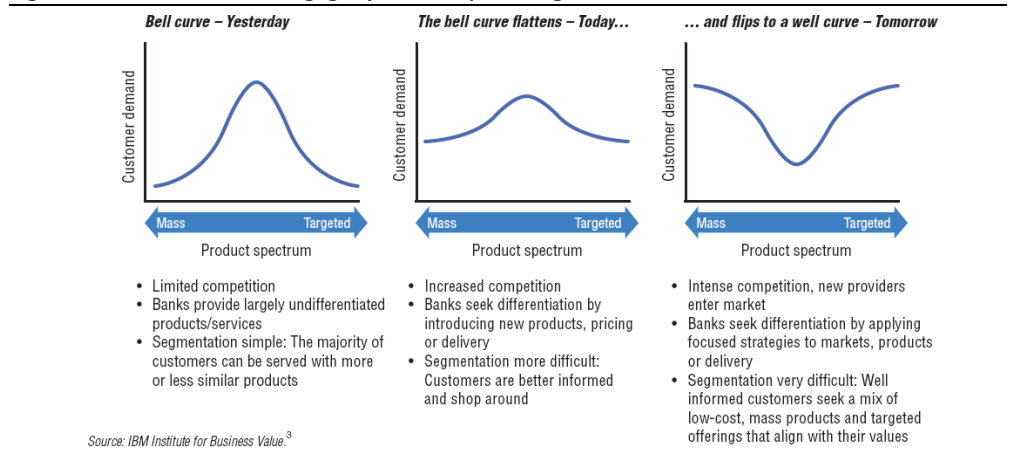
Similarly, FFF’s network effect value would be enhanced by expansion into adjacent segments. We feel there is no reason why the company’s capabilities cannot be transferred into the SME and business banking market space with inherently higher margins but comparable lead generation/decisioning processes.

General Insurance and Life Risk are other compatible possibilities given the commoditisation of a number of these products and relatively successful penetration rates through virtual channels. Finally, convergence of mortgage broking and financial planning under ASIC’s new licensing regime should also expand cross-sell opportunities for FFF.

**BREAKAWAY VALUE AS A PREFERRED STRATEGIC PARTNER**

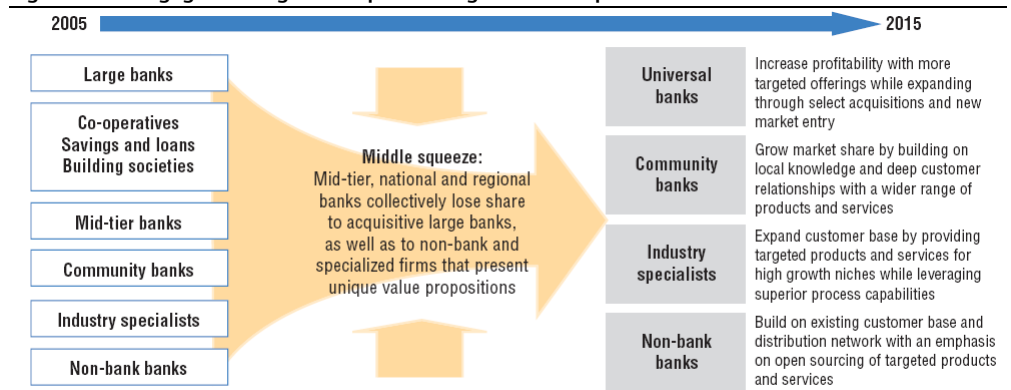
We agree with IBM’s views that margin pressure, regulatory/compliance costs, industry specialisation, customer centricity (diversity and individualism to drive a more hands-on behaviour) and emergence of new technologies will continue to heighten pressure on banks’ traditional mortgage operations<sup>2</sup> (Figure 5). With expectations for further operational efficiencies and excellence, the banks would have to continuously innovate/differentiate to retain and build market share.

**Figure 5 – The rise of the mortgage specialist – polarising customer demand**



Source: IBM Institute for Business Value.<sup>3</sup>  
SOURCE: IBM

**Figure 6 – Mortgage banking landscape evolving to benefit specialists**



Source: IBM Institute for Business Value.  
SOURCE: IBM

<sup>2</sup> IBM: Innovation in mortgage operations: the imperative for change to sustain relevance and build growth (2006); The paradox of Banking 2015 (2005).

One key area for banks to generate additional value is outsourcing. In addition to traditional core banking system outsourcing, we believe there is significant scope for banks to outsource some of their mortgage processing functions and partner with industry specialists such as FFF (Figure 6).

#### FLEXIBLE/SCALABLE SYSTEMS

#### Excess capacity to expand LUM

With a history in providing software solutions (see company profile), FFF understands the need for a loan management platform that seamlessly covers front end origination/qualification, workflow (submission to settlement) and loan management (back office).

The acquisition of eChoice in 2008 provided FFF with a scalable IT platform for E2E loan management. We understand the Java/Oracle-based platform is capable of supporting total LUM in excess of \$25bn (currently \$18bn) and settlements in excess of \$300m per month. There are no integration issues to date with \$5.5bn of LUM acquisitions since December 2009.

FFF's strategy is to increase website exposure and thus reduce the physical cost per lead. The company aims to generate up to 1,000 verified leads per month. We understand FFF's loan turnaround time is a fraction of the larger banks'.

#### THE INCREDIBLE 'BULK' (OR SIZE IS EVERYTHING)

#### Scale facilitator

We understand lenders are unlikely to deal with smaller brokers that are unable to deliver higher volumes of approvals. FFF's loan management platform provides the solution and "aggregates" sufficient home loan applications to satisfy the lenders' requirements – further building upon the network effect as described earlier.

#### ACTIVE PARTICIPANT IN SECTOR CONSOLIDATION

#### Experienced in M&A execution and integration

Through management's vision and experience in managing growth, FFF is well positioned to capitalise on the inevitable consolidation within the mortgage broking market as a result of likely lower commissions and higher regulatory costs.

The number of mortgage brokers has fallen by 40% to 15,000 in the past two years as a result of the GFC and the trend is expected to continue – particularly with mortgage brokers that are inefficient and sub-scale. We feel FFF will do well picking up additional LUM under distressed conditions and extracting further economies of scale. With its scalable IT platform and process experience, we feel FFF's future strategic relevance is assured.

#### M&A APPEAL AS AN ALTERNATE DISTRIBUTION CHANNEL

#### Potential takeover target

The major banks have recently acquired mortgage managers and aggregators as part of their customer-centric strategy to diversify their distribution channels (e.g. WBC/RAMS, CBA/Aussie and NAB/Challenger). A list of comparable transactions is listed in Appendix 1. As an alternate/cost effective distribution channel, FFF retains its strategic appeal to both the majors and smaller players lacking in physical footprints outside their respective home bases.

#### Guiding to 2010e EBITDA of \$10-11m

#### Expecting 2010 to be another record year

FFF's 1H10 EBITDA increased from \$1.1m in the prior corresponding period to \$4.5m, underpinned by 32% higher revenue to \$28.1m (reflecting the impact of acquisitions and the First Home Buyer scheme) and scale benefits. With a rebound in the economy and funding constraints easing, the company has guided to underlying EBITDA of \$10-11m in 2010e (SCE estimate \$10.6m).

**Significantly undervalued for its growth/ROE potential and M&A appeal**

## Initiating coverage with \$0.12 price target and Buy rating

The \$0.12 per share price target is based on the average of:

1. The DCF (equity) methodology (\$0.17 per share using a 12.9% hurdle rate and 3% terminal growth rate); and
2. 2010e EV/EBITDA multiple of 6 times less net debt (\$0.07 per share).

We have also factored into the DCF a discretionary \$0.5m IT expenditure per year to maintain the company's strategic advantage in virtual distribution.

The price target represents 14.0 times 2010e earnings and 8.2 times 2010e EBITDA, falling to 10.4 times and 4.6 times respectively in 2012e.

While not perfect, we believe HOM and MOC are the closest companies to benchmark FFF against (Table 2). In reality, FFF would be a blended version of HOM and MOC. We have stripped out the interest expense from HOM's net interest income for consistency in assessing net interest cover.

With improving gearing due to the recent rights issue and lower price multiples relative to ROE, FFF remains an inexpensive entry point into low risk, capital efficient virtual mortgage banking.

This is in addition to its strategic appeal and role as an active consolidator in the mortgage management/aggregation market space (with further accretive acquisitions currently on offer).

**Table 2 – FFF undervalued for its ROE potential**

IH10	Firstfolio (FFF)	Home Loans (HOM)	Mortgage Choice (MOC)
<b>P &amp; L (\$m)</b>			
Revenue	28.1	36.8	68.9
Commission expense	-16.3	-6.6	-43.7
Operating costs	-7.1	-8.3	-8.7
<b>EBITDA</b>	<b>4.8</b>	<b>21.9</b>	<b>16.5</b>
D&A	-0.6	-0.2	-0.5
<b>EBIT</b>	<b>4.1</b>	<b>21.7</b>	<b>15.9</b>
Interest costs	-0.6	-15.3	-7.6
EBITDA margin	17%	60%	24%
Commission expense / revenue	-58%	-18%	-63%
Net interest cover (times)	7.2	1.4	2.1
<b>Balance sheet (\$m)</b>			
Net debt / (cash)	37	531	90
Equity	26	65	70
Net debt / equity	143%	817%	128%
Net debt / EBITDA (times)	3.9	12.1	2.7
Loans under management (\$bn)	18	564	37
EBITDA / LUM	0.05%	0.01%	0.09%
NPBT / LUM	0.04%	0.00%	0.04%
<b>Market statistics (prospective)</b>			
P / E ratio (times)	7.2	7.2	9.5
P / EBITDA ratio (times)	4.3	1.5	4.5
EV / EBITDA ratio (times)	5.6	5.7	6.8
Net DPS (cps)	0	6	11
Yield	0.0%	8.2%	8.9%
ROE	19%	11%	22%

SOURCE: COMPANY DATA AND SOUTHERN CROSS EQUITIES ESTIMATES

## Appendix 1: Industry transaction multiples

Table 3 – Mortgages/mortgage-related transactions

Date	Acquiror	Acquiree	Consideration (\$m)	Loans under management (\$m)	P/Loans under management	Category
2009	ANZ	AWB/Landmark	16	2,400	0.67%	Agri-loans
2009	FFF	FCC	2	3,500	0.04%	Manager/aggregator
2009	FFF	LSA	15	2,000	0.77%	Manager
2009	NAB	Challenger	360	114,000	0.32%	Aggregator/originator
2008	FFF	Domain	7	1,000	0.68%	Manager
2008	FFF	e-Choice	19	2,600	0.74%	Aggregator/originator
2008	AHL/CBA	Wizard	26	4,000	0.65%	Prime/non-conforming
2008	CBA	AHL (33%)	60	24,000	0.76%	Prime/non-conforming
2008	Count	Mortgage Choice (4.9%)	6	30,500	0.40%	Aggregator
2007	FFF	Lawfund	1	5,700	0.06%	Aggregator
2007	FFF	Capital 1st loan book	2	600	6.12%	Loan book
2007	WBC	RAMS franchise	140	-	-	Brand/distribution only
2005	ABN Amro	Bluestone (39%)	150	2,000	19.13%	Non-conforming
2005	Challenger	PLAN Australia (15%)	15	20,000	0.50%	Aggregator
2005	OFM	Mortgageport (50%)	7	1,080	1.22%	Wholesale originator
2004	FFF	New Loan	1	300	2.16%	Aggregator
2004	GE Money	AFIG	442	18,000	2.46%	RMBS issuer
2003	Challenger	Interstar	85	11,000	0.77%	Prime/non-conforming
2003	Terrain	Northern City	4	1,400	0.29%	-
2002	Credit union consortium	Mortgage Choice (8%)	9	15,000	0.75%	Aggregator
2001	Homeloans	Access	11	1,400	0.75%	Resi-mortgages
2001	Homeloans	Eurofinance	2	268	0.71%	Resi-mortgages
2001	Homeloans	FAI First Mortgage	7	930	0.76%	Resi-mortgages
2000	ANZ	PIBA	100	1,500	6.67%	Prime
<b>Average</b>					<b>2.06%</b>	

SOURCE: COMPANY DATA

# Firstfolio profile

## Company history/description

FFF started as professional services and software solutions provider Midware Limited in 2000. In 2003, it entered the mortgage processing and wholesaling /management markets by acquiring The Mortgage Processing Centre and associated company Australian Wholesale Lending. This was followed by the purchase of mortgage aggregator New Loan Australia in 2004 for just under \$1m.

As part of its Go Forward Strategy, the company decided to overhaul itself and focus on growth opportunities related to innovative lending solutions (through financial product intermediaries and in particular loan originators). This is based on its competency in managing the full loan transaction life cycle from lead through settlement including ongoing management.

Midware's legal and software businesses were divested in 2004. In line with the strategy shift, the new value proposition to potential clients (e.g. individual mortgage brokers, broker groups and independent businesses providing branded lending solutions) now revolves around a strong back office platform, growing distribution network, flexibility (as compared with traditional lenders) and consistency and speed of service.

At the end of 2004, Midware changed its name to Affiance to complete its transformation into a financial services platform. This was followed by a series of acquisitions in the mortgage aggregation/management market space (see transaction details below).

The company changed its name to Firstfolio (FFF) in 2006 to reflect the core business activities of mortgage processing and management, including the provision of wholesale funds from leading financial institutions. More recently, FFF has moved into direct distribution of financial services solutions and products through its e-Choice acquisition and New Loan brand.

## Board and management

1. **Tom Hartigan (Chairman)** – Appointed Chairman in 2002 with over 20 years experience as a director of Australian public companies including Metway Bank and Midland Credit.
2. **Mark Flack (Executive Director)** – Mark is foundation Director, entrepreneur with 20 years commercial experience and a CPA for over 15 years.
3. **Anthony Wales (Non-executive Director)** – Appointed in 2002 and previously Founding and Executive (Finance) Director of Computershare.
4. **Michael Hogg (Non-executive Director)** – Global CEO of the Cobra Group, one of the world's largest face-to-face sales and marketing groups.
5. **Anthony Harris (Non-executive Director)** – Founder of the Money Store with extensive experience in construction, property and finance.
6. **Mark Forsyth (Chief Executive Officer)** – Appointed in 2006 and has a 25-year international career in corporate restructuring and business development.

## Major shareholders

1. Welas Pty Ltd (a company associated with Anthony Wales; 17.1%)
2. Citicorp Nominees Pty Limited (5.6%)
3. Mr John Barlow (4.9%)
4. Mr Mark Flack (3.4%)

(The top 20 shareholders own 55.4% of the company)

## Significant transactions

1. **The Mortgage Processing Centre Pty Limited/Australian Wholesale Lending Pty Limited (2003)**: E2E mortgage processing centre/mortgage wholesaler and aggregator; purchase price includes cash and 36m FFF shares.
2. **New Loan Australia Pty Limited (2004)**: Mortgage aggregator with \$300m LUM; purchase price \$974,000.
3. **Lawfund Australia Pty Limited (42.4%) (2006)**: Mortgage aggregator with \$5.0bn LUM; purchase price \$2.7m (cash).
4. **Lawfund Australia Pty Limited (39.3%) (2007)**: Mortgage aggregator with \$5.7bn LUM; purchase price \$3.3m (cash and shares).
5. **\$0.6bn LUM (2007)**: Acquired from Capital First; purchase price \$1.8m (cash and FFF shares).
6. **Lawfund Australia Pty Limited (18.3%) (2007)**: Mortgage aggregator with \$5.7bn LUM, over 1,000 members and a network of over 400 lending managers; purchase price \$1.1m (cash).
7. **eChoice Pty Limited (2008)**: Internet lending service provider including wholesale mortgage manager and aggregator with \$2.6bn LUM; purchase price \$19.2m (\$0.3m upfront, \$1.8m FFF shares and \$17.1m deferred over four years).
8. **Domain Financial Services Pty Limited (2008)**: Wholesale mortgage manager with \$1.0bn LUM; purchase price \$6.8m (\$0.7m upfront, \$6.1m deferred over four years).
9. **Loan Services Australia Pty Limited (2009)**: Wholesale mortgage manager with \$2.0bn LUM; purchase price \$15.4m (\$10.0m upfront, \$5.4m deferred over three years).
10. **First Chartered Capital Corporation Pty Limited (2009)**: Mortgage manager and aggregator with \$3.5bn LUM; purchase price \$1.5m (\$0.2m FFF shares, \$1.3m deferred over 1.5 years).
11. **Xplore Capital Limited (expected to complete first half 2010)**: Direct retailer and marketer of mortgage services with \$0.5bn LUM; purchase price \$3.0m (cash or cash and FFF shares).

## Investment strategy

FFF's strategy revolves around the following competencies:

1. Partnership-based business model that leverages on the network effect and facilitates rapid geographic expansion without heavy capital expenditure;
2. Strong relationships with clients;
3. Lead generation and management using direct sales experience; and
4. Innovative product and service offering.

FFF's value drivers include the ability to utilise its well-tested financial services distribution platform (sufficient capacity) to extract economies of scale from additional LUM acquisitions, earnings growth from increasing footprint in QLD, VIC and WA, and capital efficiencies leading to 20%+ ROE in the medium term.

## Valuation

The \$0.12 per share price target is based on a blended valuation of the DCF (equity) methodology (\$0.17 per share using a 12.9% hurdle rate and 3% terminal growth rate) and 2010e EV/EBITDA multiple of 6 times less net debt (\$0.07 per share), weighted equally.

We have used the DCF (equity) methodology given FFF is expected to have stable leverage post its rights issue in December 2009 and its dividend is expected to commence in 2014e once the deferred cash consideration liability is fully repaid. We have also factored into the DCF a discretionary \$0.5m IT expenditure per year to maintain the company's strategic advantage in virtual distribution.

The price target represents 14.0 times 2010e earnings and 8.2 times 2010e EBITDA, falling to 10.4 times and 4.6 times respectively in 2012e.

## SWOT analysis

### Strengths

1. Experienced management with M&A execution capabilities and integration experience;
2. Strong service culture and brand;
3. Cost efficiency with further scope for scale economies;
4. Risk management; and
5. Virtual distribution capabilities.

### Weaknesses

1. Heavily reliant on a few wholesale bank funders; and
2. Heavily reliant on the home mortgage category.

### Opportunities

1. Thawing of RMBS market to underpin sector lending efforts;
2. Mortgage broking consolidation as a result of lower commissions and regulatory reforms (licensing and compliance costs) to increase M&A growth opportunities;
3. Market adjacency opportunities, e.g. personal and SME lending products coupled with increasing wholesale bank funder willingness to lend; and
4. Capability transfer/offshore initiatives.

**Threats**

1. Risk of failing to comply with lending authority;
2. Risk of overseas lenders pulling out of Australia; and
3. Macroeconomic factors such as higher unemployment and slowing credit growth especially as the First Home Buyers scheme winds down (although the risk is dissipating given an improving local economy and a pickup in investment home loans).

# Glossary

**Aggregator** – This is essentially an “aggregator” or franchise platform to which the mortgage broker belongs. The mortgage aggregator provides support services to brokers and gets a cut of the upfront and trail commissions payable to the broker (i.e. clipping the pass-through).

As indicated earlier, we understand lenders are unlikely to deal with smaller brokers that are unable to deliver higher volumes of approvals. As an aggregator, FFF’s loan management platform provides the solution and “aggregates” sufficient home loan applications to satisfy the lenders’ requirements.

**Broker** – The mortgage broker usually works with retail and business clients as an independent service provider, determining their borrowing needs and ability to repay, and managing the process from approval through to settlement. Post-settlement, there is no more involvement with the mortgage.

The broker can only offer loans from the lender panel they are accredited with (banks, specialist non-conforming/non-bank lenders and mortgage managers). The broker is typically paid by the lender through upfront (30-70bp of the loan amount) and trail commissions (5-25bp of the loan amount over the life of the loan).

A finance broker specialises in business finance such as leasing, debtor finance, etc.

**Manager** – The mortgage manager is a specialist who organises funding from a variety of lenders and is responsible for the ongoing prudent management of the loan life cycle (e.g. credit risk assessment, repayment monitoring, insurance renewals and interest rate adjustments).

While the credit risk resides with the lender and not the mortgage manager, there are some cases in which the latter is partially liable if lending criteria and processes are not maintained. The failure to comply with the lending authority means the lender could technically ask the manager to buy out an impaired loan, although the risk is mitigated by the manager’s Professional Indemnity insurance. To enhance compliance/corporate governance, the mortgage manager is subject to regular audits by the lender (possibly every two months).

The manager is usually paid an establishment and/or management fee by the lender. We understand a variant of the mortgage manager is the wholesaler who arranges funding for clients who wish to brand their own loan products (i.e. under a white-labelling agreement).

# Firstfolio Limited

as at 17 March 2010

Recommendation

Buy

Price

\$0.062

Target (12 months)

\$0.120

Table 4 - Financial summary

Firstfolio						Share Price (A\$)						0.062
As at	17-Mar-10					Market Cap (A\$M)						45
<b>PROFIT AND LOSS</b>												
Y/e June 30 (\$m)	2008	2009	2010e	2011e	2012e	Y/e June 30	2008	2009	2010e	2011e	2012e	
Revenue from continuing ops	41.6	47.4	60.7	72.1	79.1	NPAT (statutory basis) (\$m)	-1.1	3.3	5.3	7.2	8.8	
Other income	0.1	0.1	0.2	0.2	0.2	NPAT (cash basis) (\$m)	-0.9	4.5	8.4	10.8	13.6	
<b>Total revenue</b>	<b>41.6</b>	<b>47.5</b>	<b>61.0</b>	<b>72.3</b>	<b>79.3</b>	<b>EPS (statutory) (cps)</b>	<b>-0.3</b>	<b>0.8</b>	<b>0.9</b>	<b>0.9</b>	<b>1.2</b>	
Commission expense	-31.5	-29.5	-34.2	-38.0	-39.9	- Growth	n/m	n/m	9%	10%	22%	
Processing & other expense	0.0	0.0	-1.7	-1.9	-1.9	EPS (diluted) (cps)	-0.3	0.8	0.9	0.9	1.2	
Overheads	-10.2	-12.6	-14.5	-17.2	-18.6	- Growth	n/m	n/m	9%	10%	22%	
<b>Total operating expenses</b>	<b>-41.7</b>	<b>-42.1</b>	<b>-50.4</b>	<b>-57.1</b>	<b>-60.4</b>	P / E ratio (times)	-20.7	7.9	7.2	6.6	5.4	
<b>EBITDA</b>	<b>0.0</b>	<b>5.4</b>	<b>10.6</b>	<b>15.3</b>	<b>18.9</b>	<b>P / EBITDA ratio (times)</b>	<b>Large</b>	<b>8.4</b>	<b>4.3</b>	<b>3.0</b>	<b>2.4</b>	
Depreciation	-0.2	-0.2	-0.7	-0.2	-0.2	P / Book ratio (times)	8.1	4.4	1.6	1.2	1.0	
Amortisation	0.0	-0.1	-0.1	0.0	0.0	Net DPS (cps)	0.0	0.0	0.0	0.0	0.0	
<b>EBIT</b>	<b>-0.2</b>	<b>5.1</b>	<b>9.9</b>	<b>15.1</b>	<b>18.7</b>	Yield	0%	0%	0%	0%	0%	
Finance costs	-0.9	-1.8	-3.6	-4.8	-6.1	Franking	0%	0%	0%	0%	0%	
<b>NPBT</b>	<b>-1.1</b>	<b>3.3</b>	<b>6.3</b>	<b>10.3</b>	<b>12.6</b>	Payout (statutory basis)	0%	0%	0%	0%	0%	
Income tax expense	0.0	0.0	-1.0	-3.1	-3.8	<b>PROFITABILITY RATIOS</b>						
<b>NPAT (statutory basis)</b>	<b>-1.1</b>	<b>3.3</b>	<b>5.3</b>	<b>7.2</b>	<b>8.8</b>	Y/e June 30	2008	2009	2010e	2011e	2012e	
Non-cash adjustments	0.2	1.2	3.1	3.6	4.8	EBITDA / total revenue	0%	11%	17%	21%	24%	
<b>NPAT (cash basis)</b>	<b>-0.9</b>	<b>4.5</b>	<b>8.4</b>	<b>10.8</b>	<b>13.6</b>	<b>EBIT / total revenue</b>	<b>0%</b>	<b>11%</b>	<b>16%</b>	<b>21%</b>	<b>24%</b>	
<b>CASHFLOW</b>						ROA	-5.2%	6.7%	7.0%	9.3%	10.9%	
Y/e June 30 (\$m)	2008	2009	2010e	2011e	2012e	ROE	-21%	36%	19%	21%	21%	
EBITDA	0.0	5.4	10.6	15.3	18.9	ROFE	-7%	16%	16%	15%	16%	
Change in working capital	1.5	12.4	-3.3	0.1	-3.4	Dividend cover (times)	n/m	n/m	n/m	n/m	n/m	
Net interest	-0.9	-1.8	-3.6	-4.8	-6.1	Effective tax rate	0%	0%	16%	30%	30%	
Tax paid	0.0	0.0	-1.0	-3.1	-3.8	<b>LIQUIDITY / LEVERAGE RATIOS</b>						
<b>Operating cashflow</b>	<b>0.6</b>	<b>15.9</b>	<b>2.7</b>	<b>7.4</b>	<b>5.6</b>	Y/e June 30	2008	2009	2010e	2011e	2012e	
Capex	0.0	0.0	0.0	0.0	0.0	Net debt / (cash) (\$m)	11.8	12.6	14.3	16.1	15.5	
Other	0.0	-0.9	-0.8	0.0	0.0	Net debt / equity	211%	122%	49%	45%	35%	
<b>Investing cash flow</b>	<b>0.0</b>	<b>-0.9</b>	<b>-0.8</b>	<b>0.0</b>	<b>0.0</b>	Net interest cover (times)	-0.2	2.8	2.7	3.1	3.0	
Equity raised	1.1	1.8	13.4	0.0	0.0	Net debt / EBITDA (times)	n/m	2.3	1.3	1.1	0.8	
Dividends paid	0.0	0.0	0.0	0.0	0.0	Current ratio (times)	0.6	0.3	0.6	0.6	0.9	
Borrowings	1.6	-3.3	10.8	1.5	1.0	Cash cycle (days)						
Other	-5.2	-13.2	-23.6	-7.8	-4.0	- Payables	48	59	88	85	85	
<b>Financing cashflow</b>	<b>-2.5</b>	<b>-14.6</b>	<b>0.7</b>	<b>-6.3</b>	<b>-3.0</b>	- Receivables	41	40	58	55	55	
Net change in cash	-1.9	0.4	2.5	1.1	2.6	- Net cash cycle	7	20	30	30	30	
<b>Cash at end of period</b>	<b>0.3</b>	<b>0.7</b>	<b>3.2</b>	<b>4.4</b>	<b>7.0</b>	<b>EV / EBITDA (times)</b>	<b>n/m</b>	<b>11.0</b>	<b>5.6</b>	<b>3.9</b>	<b>3.1</b>	
<b>BALANCE SHEET</b>						<b>INTERIMS</b>						
Y/e June 30 (\$m)	2008	2009	2010e	2011e	2012e	1H09	2H09	1H10	2H10e	1H11e		
Cash and cash equivalents	0.3	0.7	3.2	4.4	7.0	Revenue from continuing ops	21.3	26.1	28.1	32.6		
Receivables	4.6	5.1	9.6	10.9	11.9	Other income	0.0	0.0	0.1	0.1		
<b>Current assets</b>	<b>4.9</b>	<b>5.8</b>	<b>12.8</b>	<b>15.2</b>	<b>18.8</b>	<b>Total revenue</b>	<b>21.3</b>	<b>26.1</b>	<b>28.3</b>	<b>32.7</b>		
Deferred tax assets	0.7	0.7	0.0	0.0	0.0	Commission expense	-14.7	-14.7	-16.3	-17.9		
Intangibles	16.2	41.0	60.6	60.6	60.6	Processing & other expense	0.0	0.0	-0.8	-0.9		
PP&E	0.3	0.3	0.3	0.4	0.4	Overheads	-5.5	-7.1	-6.7	-8.4		
Other assets	0.2	1.1	1.9	1.9	1.9	<b>Total operating expenses</b>	<b>-20.2</b>	<b>-21.8</b>	<b>-23.8</b>	<b>-26.6</b>		
<b>Total assets</b>	<b>22.2</b>	<b>48.9</b>	<b>75.6</b>	<b>78.1</b>	<b>81.7</b>	<b>EBITDA</b>	<b>1.1</b>	<b>4.3</b>	<b>4.5</b>	<b>6.1</b>		
Payables	4.1	4.8	8.2	8.8	9.3	Depreciation	-0.1	-0.1	-0.6	-0.1		
Loans	3.7	8.1	1.5	3.0	4.0	Amortisation	0.0	-0.1	-0.1	0.0		
Deferred cash consideration	0.0	7.7	8.3	7.6	3.8	<b>EBIT</b>	<b>1.0</b>	<b>4.1</b>	<b>3.8</b>	<b>6.1</b>		
Other current liabilities	0.4	0.5	4.1	4.1	4.1	Finance costs	-0.5	-1.3	-1.6	-2.0		
<b>Current liabilities</b>	<b>8.2</b>	<b>21.0</b>	<b>22.2</b>	<b>23.5</b>	<b>21.2</b>	<b>NPBT</b>	<b>0.5</b>	<b>2.8</b>	<b>2.2</b>	<b>4.0</b>		
Loans	8.5	5.2	16.0	17.5	18.5	Income tax expense	0.0	0.0	0.0	-1.0		
Other borrowings	0.0	0.0	0.0	0.0	0.0	<b>NPAT (statutory basis)</b>	<b>0.5</b>	<b>2.8</b>	<b>2.2</b>	<b>3.0</b>		
Deferred cash consideration	0.0	12.3	11.4	3.8	0.0	Non-cash adjustments	0.1	1.1	1.7	1.5		
Other liabilities	0.0	0.1	-2.9	-2.9	-2.9	<b>NPAT (cash basis)</b>	<b>0.6</b>	<b>3.9</b>	<b>3.9</b>	<b>4.5</b>		
<b>Total liabilities</b>	<b>16.6</b>	<b>38.6</b>	<b>46.6</b>	<b>41.9</b>	<b>36.7</b>	EPS (statutory) (cps)	0.1	0.7	0.5	0.4		
Contributed equity	25.3	27.1	40.6	40.6	40.6	Net DPS (cps)	0.0	0.0	0.0	0.0		
Reserves	2.5	2.7	2.7	2.7	2.7	EBITDA / total revenue	5%	16%	16%	19%		
Retained earnings	-22.2	-19.5	-14.3	-7.1	1.7	EBIT / total revenue	5%	16%	14%	19%		
<b>Total shareholders' equity</b>	<b>5.6</b>	<b>10.3</b>	<b>29.0</b>	<b>36.2</b>	<b>45.0</b>	ROE	14%	61%	24%	22%		
<b>Total sh. equity &amp; liabs.</b>	<b>22.2</b>	<b>48.9</b>	<b>75.6</b>	<b>78.1</b>	<b>81.7</b>							
<b>Total funds employed</b>	<b>17.4</b>	<b>22.9</b>	<b>43.3</b>	<b>52.3</b>	<b>60.5</b>							
<b>WANOS - basic (m)</b>	<b>369</b>	<b>417</b>	<b>613</b>	<b>761</b>	<b>761</b>							
<b>WANOS - diluted (m)</b>	<b>375</b>	<b>417</b>	<b>613</b>	<b>761</b>	<b>761</b>							

SOURCE: SOUTHERN CROSS EQUITIES ESTIMATES

**Recommendation structure**

Spec Buy: Expect >30% total return on a 12 month view but carries significantly higher risk than its sector

Buy: Expect >15% total return on a 12 month view

Accumulate: Expect total return between 0% and +15% on a 12 month view

Reduce: Expect -15% and 0% total return on a 12 month view

Sell: Expect <-15% total return on a 12 month view

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Southern Cross Equities Ltd and its associates hold 21,372,000 shares in FFF as at the date of this report. This position is subject to change without notice.

Disclosure: Southern Cross Equities acted as underwriter/lead manager of a 1:2 rights issue to raise \$12.1m in December 2009 and received a fee.