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Firstfolio Limited (FFF)

Extra cake in there

Recommendation
Buy (unchanged)
Price
\$0.046
Target (12 months)
\$0.096 (previously \$0.115)

Expected Return

Capital growth	108.7%
Dividend yield	0.0%
Total expected return	108.7%

Company Data & Ratios

Enterprise value	\$89m
Market cap	\$35m
Issued capital	765m
Free float	75.8%
Avg. daily vol. (52wk)	(545,581)
12 month price range	\$0.040 - \$0.072

GICS sector

Diversified Financials

Price Performance

	(1m)	(3m)	(12m)
Price (A\$)	0.06	0.05	0.06
Absolute (%)	-16.36	-6.12	-24.59
Rel market (%)	-5.82	6.92	-17.76

Absolute Price



SOURCE: IRESS

BELL POTTER SECURITIES LIMITED
ACN 25 006 390 7721
AFSL 243480

Cost effective distribution channel

As a virtual mortgage lender, FFF operates without the usual restrictions faced by the banks. These include credit risk, infrastructure constraints and excess capital/liquidity requirements. The emergence of specialist fighting brands amongst the majors is designed to provide choice to customers and sustain growth in a soft yet competitive credit environment. FFF would strategically enhance the banks' overall distribution capabilities at a far lower cost, either as a takeover target or strategic partner.

Solid 2011 performance despite headwinds

FFF increased 2011 NPAT by 42% to \$6.4m and operating EBITDA (excluding \$3.7m of acquisition and restructuring costs) by 49% to \$15.6m. This was largely due to contributions from recent acquisitions (e.g. Club Financial Services and Apple Loans), margin management (operating EBITDA margin increased by 1% to 17%) and tight cost control (overheads as a % of revenue decreased by 1% to 24%). Operating EBITDA was short of the \$17-18m guidance largely as a result of the QLD floods (20% of all loans sourced from the state). While YTD momentum and resilient margins have led FFF to provide operating EBITDA guidance of \$19-21m for 2012, we have opted for conservatism at this point and have forecast just under \$19m instead. Because of a higher amortisation rate for contract rights acquired and continuing softness in the housing market leading to likely pressure on residual revenues, we have lowered out NPAT estimates across the forecast horizon by up to 16%.

Double your money – price target 9.6cps, maintain Buy

The revised price target of 9.6cps (previously 11.5cps) reflects the above earnings changes and is only 1.6cps higher than FFF's de-risked/run-off value (i.e. running off the legacy book and collecting residual revenue without writing new business). With scalable B2B and B2C platforms, a highly variable cost base, forward PE of under 5x and ROE prospects in the high teens, FFF remains an inexpensive entry point into the world of virtual mortgage lending for big and small banks alike. The company remains at a deep discount to its inherent value and we retain the Buy rating.

Earnings Forecast

Year end 30 June	2010	2011	2012e	2013e
Revenue (A\$m)	65.8	89.2	103.4	106.2
Operating EBITDA (A\$m)	10.5	15.6	18.7	20.3
NPAT (normalised) (eps)	6.1	9.1	7.6	8.5
NPAT (reported) (eps)	4.5	6.4	7.6	8.5
EPS (reported) (eps)	0.7	0.8	1.0	1.1
EPS growth (%)	16%	13%	18%	12%
PER (x)	6.1	5.4	4.6	4.1
FCF yield (%)	4.1%	16.1%	28.1%	31.9%
EV/EBITDA (x)	8.5	5.7	4.7	4.4
DPS(eps)	0.0	0.0	0.0	0.0
Yield (%)	0%	0%	0%	0%
ROE (%)	23%	27%	20%	19%

SOURCE: BELL POTTER SECURITIES ESTIMATES

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Double your money

Price target 9.6cps, maintain Buy

FFF has guided to operating EBITDA of \$19-21m for 2012. However, home lending (being FFF's only product offering at present) remains soft and we have instead forecast \$18.7m for the period (we have opted to be conservative with the company having missed their guidance in 2011). Changes to our estimates are highlighted in Table 1 and this also includes a higher amortisation rate for contract rights.

The price target of 9.6cps (previously 11.5cps) is based on a blended valuation of the DCF methodology of 15cps (using a 13% hurdle rate and 3% terminal growth rate, weighted 50%), 1.1cps value based on 2012e EV/EBITDA multiple of 3x (weighted 20%), runoff value of 8cps (weighted 10%) and strategic value of 5.5cps (20% premium, weighted 20%).

The price target represents 8.6x 2013e earnings and compares favourably to the banks given a higher prospective ROE of around 18-19%. Our Buy rating is also underpinned by FFF's strategic attributes including:

1. **Active participant in sector consolidation** – FFF is well placed to capitalise on the inevitable consolidation in the mortgage broking market as a result of lower commissions and higher regulatory costs. The number of mortgage brokers has fallen by 40% to 15,000 in the past few years following the GFC and the trend is expected to continue –with additional scale at distressed prices and potential economies of scale.
2. **Expansion into adjacent segments** – With its current platforms, FFF would be able to replicate its successes in the Asset Finance (spreads double that of mortgages) and Wealth space.
3. **Volatility enhances profitability** – FFF should thrive in a volatile rate environment, likely winning market share from greater churn within the larger players (that would translate into higher upfront and trail commissions).
4. **M&A appeal as an alternate distribution channel or strategic partner** – One key area for banks and non-banks is to expand their distribution reach without additional fixed costs. FFF remains well-placed to assume this functionality given a variable cost component of around 80-85%.

Table 1 – Rebasing estimates for slower credit growth

(A\$m)	2011		2012e		2013e	
	Actual	Variance	New	Change	New	Change
NPAT (reported) (A\$m)	6.4	-7%	7.6	-10%	8.5	-16%
Operating EBITDA (\$m)	15.6	-4%	18.7	3%	20.3	0%
EPS (reported) (cps)	0.8	-8%	1.0	-10%	1.1	-17%
EPS growth (%)	13%	-27%	18%	17%	12%	-8%
Net DPS (cps)	0	0%	0	0%	0	0%
ROE (%)	27%	4%	20%	0%	19%	0%

SOURCE: COMPANY DATA AND BELL POTTER SECURITIES ESTIMATES

Firstfolio profile

Company description

The company has a focus on innovative lending solutions. The value proposition to potential 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. The three core businesses are described below.

WHOLESALE

Trading under the **Firstfolio Wholesale** brand, clients are largely sub-originators (who brand their own products through a white label arrangement, e.g. MyRate and HomeStar). LUM is around \$6bn with funding sourced from major institutions including ING and Adelaide Bank. Main competitors include FirstMac and RESIMAC. The value drivers include upfront 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.

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 around \$4bn with funding sourced from 20+ panel lenders including the majors, specialist lenders, ING and Adelaide. Competition largely comes from Mortgage Choice and Aussie. 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. The margin is 2x that of the Wholesale business. **New-Loan's** LUM is around \$3bn 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, the operating margin being 1.5x that of the Wholesale business.

AGGREGATION

The clients of Firstfolio Aggregation and Firstfolio One are brokers. LUM is just over \$9bn 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). 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.

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. **Greg Paramor (Non-executive Director)** – Founding partner of Equity Real Estate Partners and CEO of Mirvac from 2004-08 with more than 35 years real estate/funds management experience; currently on the LJ Hooker Board.
7. **Mark Forsyth (Chief Executive Officer/Director)** – 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; 16.2%)
2. Mr John Barlow (4.7%)
3. Mr Mark Flack (3.3%).

(The top 20 shareholders own 53.9% of the company)

Investment strategy

FFF's strategy revolves around a partnership-based model (that facilitates rapid geographic expansion without heavy capital expenditure). FFF's value drivers include the ability to utilise its well-tested financial services distribution platform to extract economies of scale from additional LUM acquisitions, earnings growth from increasing footprint in QLD, VIC and WA, and capital efficiencies leading to ROE in the high teens.

SWOT analysis

Strengths

1. Experienced team with M&A execution/integration and risk capabilities;
2. Strong service culture and brand;
3. Cost efficiency with further scope for scale economies; and
4. 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; and
4. Capability transfer/offshore initiatives.

Threats

1. Risk of failure 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.

Table 2 – Financial summary

Firstfolio						Share Price (A\$)						0.046
As at	22-Aug-11					Market Cap (A\$M)						35
PROFIT AND LOSS												
Y/e June 30 (\$m)	2010	2011	2012e	2013e	2014e							
Revenue from continuing ops	65.7	88.9	103.1	105.9	106.4							
Other income	0.1	0.3	0.3	0.3	0.3							
Total revenue	65.8	89.2	103.4	106.2	106.7							
Commission expense	-37.6	-50.4	-58.5	-59.5	-60.5							
Processing & other expense	-1.5	-1.8	-2.4	-2.4	-2.4							
Overheads	-16.2	-21.5	-23.8	-24.0	-23.5							
Total operating expenses	-55.3	-73.6	-84.7	-85.9	-86.4							
Operating EBITDA	10.5	15.6	18.7	20.3	20.4							
Depreciation	-1.2	-0.4	-0.8	-0.8	-0.8							
Amortisation	-0.1	-3.6	-3.5	-2.1	-2.1							
EBIT	9.2	11.6	14.4	17.5	17.5							
Finance costs	-3.1	-4.6	-5.6	-5.3	-4.3							
NPBT	6.1	7.0	8.8	12.2	13.2							
Income tax expense	0.0	2.1	-1.2	-3.7	-4.0							
NPAT (normalised basis)	6.1	9.1	7.6	8.5	9.2							
One-offs	-1.6	-2.7	0.0	0.0	0.0							
NPAT (statutory basis)	4.5	6.4	7.6	8.5	9.2							
CASHFLOW												
Y/e June 30 (\$m)	2010	2011	2012e	2013e	2014e							
EBITDA	10.5	15.6	18.7	20.3	20.4							
Change in working capital	-5.7	-6.5	-2.0	-0.1	0.1							
Net interest	-3.1	-4.6	-5.6	-5.3	-4.3							
Tax paid	0.0	2.1	-1.2	-3.7	-4.0							
Operating cashflow	1.7	6.6	9.9	11.3	12.2							
Capex	-0.2	-0.9	0.0	0.0	0.0							
Other	-1.9	1.9	0.0	0.0	0.0							
Investing cash flow	-2.1	1.0	0.0	0.0	0.0							
Equity raised	12.8	1.4	0.0	0.0	0.0							
Dividends paid	0.0	0.0	0.0	0.0	-0.8							
Borrowings	19.0	31.7	0.0	0.0	0.0							
Other	-29.6	-39.6	-3.8	-3.9	-3.2							
Financing cashflow	2.2	-6.5	-3.8	-3.9	-4.0							
Net change in cash	1.8	1.0	6.0	7.3	8.2							
Cash at end of period	2.5	3.5	9.5	16.8	25.0							
BALANCE SHEET												
Y/e June 30 (\$m)	2010	2011	2012e	2013e	2014e							
Cash and cash equivalents	2.5	3.5	9.5	16.8	25.0							
Receivables	8.5	9.4	10.7	11.0	11.0							
Current assets	10.9	12.8	20.2	27.8	36.1							
Deferred tax assets	0.7	4.8	0.0	0.0	0.0							
Intangibles	65.2	89.3	85.8	83.7	81.6							
PP&E	0.6	1.5	1.5	1.5	1.6							
Other assets	2.9	1.1	1.1	1.1	1.1							
Total assets	80.3	109.5	108.6	114.1	120.3							
Payables	8.2	8.6	9.8	10.0	10.1							
Loans	1.5	1.0	1.0	1.0	1.0							
Deferred cash consideration	8.0	1.9	0.0	0.0	0.0							
Other current liabilities	0.9	1.6	1.6	1.6	1.6							
Current liabilities	18.6	13.0	12.4	12.5	12.7							
Loans	24.2	55.9	55.9	55.9	55.9							
Other borrowings	0.0	0.0	0.0	0.0	0.0							
Deferred cash consideration	9.3	4.7	0.0	0.0	0.0							
Other liabilities	0.2	0.3	0.3	0.3	0.3							
Total liabilities	52.4	73.9	68.5	68.7	68.8							
Contributed equity	39.9	41.3	41.3	41.3	41.3							
Reserves	2.7	2.9	2.9	2.9	2.9							
Retained earnings	-14.7	-8.6	-4.1	1.2	7.3							
Total shareholders' equity	28.0	35.6	40.1	45.4	51.5							
Total sh. equity & liabs.	80.3	109.5	108.6	114.1	120.3							
Total funds employed	51.2	89.0	87.4	85.5	83.3							
WANOS - basic (m)	604	759	765	765	765							
WANOS - diluted (m)	617	759	765	765	765							
VALUATION DATA												
Y/e June 30	2010	2011	2012e	2013e	2014e							
NPAT (normalised) (\$m)	6.1	9.1	7.6	8.5	9.2							
NPAT (statutory) (\$m)	4.5	6.4	7.6	8.5	9.2							
EPS (statutory) (cps)	0.7	0.8	1.0	1.1	1.2							
- Growth	16%	13%	18%	12%	8%							
EPS (diluted) (cps)	0.7	0.8	1.0	1.1	1.2							
- Growth	14%	15%	18%	12%	8%							
P / E ratio (times)	6.1	5.4	4.6	4.1	3.8							
P / EBITDA ratio (times)	3.4	2.3	1.9	1.7	1.7							
P / Book ratio (times)	1.3	1.0	0.9	0.8	0.7							
Net DPS (cps)	0.0	0.0	0.0	0.0	0.1							
Yield	0%	0%	0%	0%	2%							
Franking	0%	0%	0%	0%	0%							
Payout (statutory basis)	0%	0%	0%	0%	8%							
PROFITABILITY RATIOS												
Y/e June 30	2010	2011	2012e	2013e	2014e							
EBITDA / total revenue	16%	17%	18%	19%	19%							
EBIT / total revenue	14%	13%	14%	16%	16%							
ROA	7.9%	8.5%	7.0%	7.6%	7.8%							
ROE	23%	27%	20%	19%	18%							
ROFE	17%	13%	9%	10%	11%							
Dividend cover (times)	n/m	n/m	n/m	n/m	12.1							
Effective tax rate	0%	-30%	14%	30%	30%							
LIQUIDITY / LEVERAGE RATIOS												
Y/e June 30	2010	2011	2012e	2013e	2014e							
Net debt / (cash) (\$m)	23.3	53.4	47.4	40.1	31.9							
Net debt / equity	83%	150%	118%	88%	62%							
Net interest cover (times)	3.0	2.5	2.6	3.3	4.1							
Net debt / EBITDA (times)	2.2	3.4	2.5	2.0	1.6							
Current ratio (times)	0.6	1.0	1.6	2.2	2.8							
Cash cycle (days)												
- Payables	80	62	61	61	61							
- Receivables	47	38	38	38	38							
- Net cash cycle	33	24	23	23	23							
EV / EBITDA (times)	8.5	5.7	4.7	4.4	4.4							
INTERIMS												
	1H10	2H10	1H11	2H11	1H12e							
Revenue from continuing ops	28.1	37.5	43.5	45.5	51.2							
Other income	0.1	0.0	0.2	0.2	0.2							
Total revenue	28.3	37.5	43.6	45.6	51.3							
Commission expense	-16.3	-21.3	-24.6	-25.8	-29.1							
Processing & other expense	-0.8	-0.8	-0.8	-1.0	-1.2							
Overheads	-6.7	-9.4	-10.7	-10.8	-11.8							
Total operating expenses	-23.8	-31.5	-36.1	-37.5	-42.1							
Operating EBITDA	4.4	6.0	7.5	8.1	9.2							
Depreciation	-0.6	-0.6	-0.5	0.1	-0.4							
Amortisation	-0.1	0.0	-0.2	-3.3	-2.5							
EBIT	3.8	5.4	6.8	4.8	6.4							
Finance costs	-1.6	-1.5	-2.1	-2.5	-2.8							
NPBT	2.2	3.9	4.7	2.3	3.6							
Income tax expense	0.0	0.0	-0.6	2.7	0.0							
NPAT (normalised basis)	2.2	3.9	4.1	5.0	3.6							
One-offs	0.0	-1.6	-1.4	-1.3	0.0							
NPAT (statutory basis)	2.2	2.3	2.8	3.7	3.6							
EPS (statutory) (cps)	0.5	0.3	0.4	0.5	0.5							
Net DPS (cps)	0.0	0.0	0.0	0.0	0.0							
EBITDA / total revenue	16%	16%	17%	18%	18%							
EBIT / total revenue	13%	14%	16%	11%	12%							
ROE	25%	29%	28%	29%	20%							

SOURCE: BELL POTTER SECURITIES 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 -5% and 15% on a 12 month view

Hold: Expect total return between -5% and 5% on a 12 month view

Reduce: Expect total return between -15% and -5% on a 12 month view

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

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