Australian Finance Group

Yield and growth, this has both

- We initiate coverage on AFG with an ADD recommendation.
- The stock offers attractive growth prospects as well as an attractive fully franked FY17F dividend yield of 7.8%, on our estimates.
- Good cash flows being generated by AFG’s loan book support the dividend outlook. AFG’s earnings diversification strategy and scalable business model provide scope for attractive earnings growth.
- We expect total shareholder return of 44% over the next 12 months on a gross basis.

It’s a growth stock...

AFG has grown its total loan book at roughly double the level of system home loan growth over the last few years and we expect this dynamic to continue over our forecast period as AFG looks to increase the number of brokers in its network. While we expect net commission income growth to lag total loan book growth as broker payout ratios increase, we expect cost growth to be less than total income growth, resulting in attractive earnings growth. AFG’s strong cash position, potential for industry consolidation and increasing focus on industry-disruptive technological innovations also augur well for its growth outlook.

...with an attractive dividend yield

Based on our forecasts, AFG is currently offering an attractive fully franked FY17F dividend yield of 7.8%. The business is generating healthy cash flows from its loan book and the Board is targeting a dividend payout ratio of between 70% and 80% of Underlying Earnings. We expect the payout ratio to be at the upper end of this range over our forecast period and we expect dividends to be fully franked over this period.

Earnings diversification strategy is exciting

While wholesale broking of residential mortgages is at the core of AFG’s business model, AFG is increasingly focused on diversifying its product offering by focusing on commercial loans as well as by growing white label product settlements within the home lending space. These products come with higher margin potential as the upfront and trail commissions retained by AFG on white label products are higher than other home loan products. Whilst commission rates associated with commercial lending products can be less than those associated with residential lending products, deal flow in the commercial space is larger which works well given the large degree of cost leverage in the business model. In the commercial space, AFG is particularly focused on vehicle finance, personal loans and commercial mortgages.

Investment view

We initiate coverage on AFG with an ADD recommendation. Our target price, based on our dividend discount model valuation, is $1.60, representing 33% upside to the current share price of $1.20. In addition, the stock is offering a fully franked FY17F dividend yield of 7.8%, resulting in an expected total shareholder return of 44% over the next 12 months on a gross basis.

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**ADD**

Current price: A$1.20  
Target price: A$1.60  
Previous target: A$  
Up/downside: 33.3%  
Reuters: AFG.AX  
Bloomberg: AFG AU  
Market cap: US$192.1m  
A$257.8m  
Average daily turnover: US$0.27m  
A$0.36m  
Current shares o/s 214.8m  
Free float: 100.0%  

**Price performance**  
1M 3M 12M  
Absolute (%) 0 -3.2 9.1  
Relative (%) -4.8 -3.5 3.7  

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**Financial Summary**

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<tbody>
<tr>
<td>Net Profit (A$m)</td>
<td>20.38</td>
<td>22.67</td>
<td>25.28</td>
<td>27.90</td>
<td>30.97</td>
</tr>
<tr>
<td>Normalised EPS (A$)</td>
<td>0.07</td>
<td>0.11</td>
<td>0.12</td>
<td>0.13</td>
<td>0.14</td>
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<tr>
<td>Normalised EPS Growth</td>
<td>48.1%</td>
<td>11.5%</td>
<td>10.4%</td>
<td>11.0%</td>
<td></td>
</tr>
<tr>
<td>FD Normalised P/E (x)</td>
<td>11.37</td>
<td>10.20</td>
<td>9.24</td>
<td>8.32</td>
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</tr>
<tr>
<td>DPS (A$)</td>
<td>0.00</td>
<td>0.08</td>
<td>0.09</td>
<td>0.10</td>
<td>0.11</td>
</tr>
<tr>
<td>Dividend Yield</td>
<td>0.00%</td>
<td>7.00%</td>
<td>7.78%</td>
<td>8.58%</td>
<td>9.52%</td>
</tr>
<tr>
<td>BVPS (A$)</td>
<td>0.34</td>
<td>0.41</td>
<td>0.72</td>
<td>0.97</td>
<td>1.24</td>
</tr>
<tr>
<td>P/BV (x)</td>
<td>3.57</td>
<td>2.91</td>
<td>1.67</td>
<td>1.24</td>
<td>0.97</td>
</tr>
<tr>
<td>ROE</td>
<td>28.2%</td>
<td>20.8%</td>
<td>15.4%</td>
<td>13.1%</td>
<td></td>
</tr>
<tr>
<td>% Change In Normalised EPS Estimates</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Normalised EPS/consensus EPS (x)</td>
<td>1.06</td>
<td>1.05</td>
<td>1.04</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
# Contents

**Investment thesis** ............................................................................................................ 3  
Industry growth outlook is solid 3  
AFG has been increasing market share 3  
Increased scrutiny of the industry by regulators has potential to benefit AFG 3  
Earnings diversification strategy is also an advantage 4  
Potential for upside from industry-disruptive innovations 4  
Growth stock with attractive dividend yield 4  
**Valuation** ............................................................................................................................. 4  
**FY16 performance against prospectus forecasts** ......................................................... 5  
**About AFG** .......................................................................................................................... 5  
How does AFG generate income? 6  
What is AFG’s growth strategy? 6  
**Wholesale broking business** .......................................................................................... 6  
AFG Broker network 6  
AFG Broker value proposition 8  
Competition 9  
Increasing settlements and loan book driving commission revenue 10  
Outlook for commission revenue 12  
**White label mortgage business** ...................................................................................... 14  
**AFG Securities business** .................................................................................................. 14  
**Costs** .................................................................................................................................. 15  
**Dividends** ......................................................................................................................... 16  
**Gearing** .................................................................................................................................. 16  
**Risks** .................................................................................................................................. 16  
**Board of directors** .............................................................................................................. 19
Finance Companies | Australia | Equity research | December 7, 2016

Investment thesis

Industry growth outlook is solid

The mortgage broking industry has been increasing in dominance with the broker channel accounting for ~52% of home loan flows in the year ended 30 June 2016. This percentage is up from ~2% in 1994. With the government focused on ensuring that the mortgage market remains competitive, broker penetration of home loan flows has scope to increase further in time.

We also note that the Deloitte Australian Mortgage Report 2016 asked a roundtable of banks, non-banks, mortgage aggregators and fintech providers what proportion of settlements brokers will generate in three years’ time. Most respondents believed broker market share would be in the range of 51-60%.

AFG has been increasing market share

AFG has been increasing its market share of system housing finance settlements particularly as a result of actively recruiting brokers. Whilst increasing broker numbers has meant increasing broker payout ratios and has resulted in decreasing net upfront and net trail commission rates for AFG, the large extent of cost leverage in AFG’s business model has meant that generally each additional dollar of income has been coming at no incremental cost.

Increased scrutiny of the industry by regulators has potential to benefit AFG

ASIC is currently conducting a review into mortgage broker remuneration at the request of the Government and ASIC’s report is expected to be provided to the Government by the end of this month. While on the face of it, the review poses downside risk for aggregators, we believe there is more upside risk than downside risk for AFG stemming from this review for a number of reasons:

- As a result of increasing scrutiny of the mortgage broking industry by regulators, brokers are likely to be increasingly inclined towards aligning themselves with a large aggregator group such as AFG. AFG and Connective are comfortably the largest aggregators by volume, with each of these groups accounting for just under 20% of broker volumes. We believe the third largest aggregator by volume only accounts for ~8% of total broker volumes. Increased scrutiny of the industry is likely to result in the uptrend in payout ratios levelling off earlier than otherwise would have been the case. At the same time, we are not expecting lenders to reduce commission rates, which means the downtrend in AFG’s net commission rates can be expected to level off over the next couple of years.

- If compliance costs for the industry increase, this will work against smaller aggregators who do not have sufficient scale to absorb the additional costs. This creates scope for attractive acquisition opportunities for AFG. We do expect to see industry consolidation in coming years.

- We believe if the review into mortgage broker remuneration results in any change, then the most likely change will be a shift to standardised commission structures. If this does occur then we do not expect AFG to be materially impacted as 80-90% of AFG’s business is written with almost identical commission structures. That is, we do not expect AFG’s average commission rate to be materially impacted by a shift to a standardised industry commission structure.
Earnings diversification strategy is also an advantage

AFG’s diversification strategy includes focusing on white label home loan products and commercial lending. White label home loan products generate higher commission rates for AFG, meaning that if AFG grows white label settlements faster than other home loan settlements, its average commission rate can be expected to increase with all else constant. On the commercial lending front, whilst the products generally come with lower commission rates attached than home loan products, the deal flow associated with commercial loan products is generally much larger, which assists AFG’s earnings growth due to the cost leverage in the business model.

Potential for upside from industry-disruptive innovations

Looking further down the track, we believe a game changer for mortgage aggregators can be industry-disrupting innovations on the online/digital front. If aggregators are able to access consumers/borrowers directly through the online channel then they can potentially retain all of the commissions associated with products sold through this channel. AFG is already dedicating more resources to technological innovation with work on a direct-to-consumer piece being part of the plans. Furthermore, AFG has already shifted much of its IT systems to the cloud, which positions it well for innovation going forward.

However, the potential for industry disruption through technological innovation also creates downside risk for AFG as an existing competitor or new entrant may beat AFG in the race on this front, creating the risk of market share loss for AFG (at least temporarily).

Growth stock with attractive dividend yield

AFG’s loan book is generating good cash flows which bodes well for both the dividend outlook and growth outlook of the company. The stock is currently trading on a FY17 fully franked dividend yield of 7.9% on our forecasts and is also offering attractive growth potential.

Valuation

Our target price, based on our dividend discount model valuation, is $1.60, representing 33% upside to the current share price. In addition, the stock is offering a fully franked FY17F dividend yield of 7.8%, resulting in an expected total shareholder return of 44% over the next 12 months on a gross basis.

We believe the stock is currently undervalued for three reasons in particular:

- Time in market i.e. new to the ASX
- Misplaced concerns about regulatory risks
- Stock is not very liquid.

With increasing time in the market and better understanding of regulatory risks on the part of the market, we expect the stock to re-rate up to our target price.

On our forecasts, AFG is currently trading on an FY17F P/E of 10.2x. There are no other ASX-listed wholesale mortgage brokers. The closest related listed company is Mortgage Choice (ticker: MOC; not covered), which has a franchisor model. MOC is currently trading on an FY17F P/E of 13.2x based on Factset consensus forecasts, despite consensus forecasts factoring in earnings growth of only 6% in FY17 and 2% in FY18 compared with our forecasts of 12%/10%/11% for AFG in FY17F/FY18F/FY19F respectively.
**FY16 performance against prospectus forecasts**

AFG listed on the ASX in May 2015. The figure below shows AFG’s FY16 financial performance against prospectus forecasts. FY16 NPAT of $22.644m came in 15% higher than the prospectus forecast of $19.675m.

![Figure 1: FY16 prospectus forecast tracking](image)

**About AFG**

AFG is a wholesale mortgage broker (mortgage aggregator) which was founded in 1994.

Wholesale mortgage brokers and franchisors provide the link between mortgage brokers and most lenders. Both wholesale mortgage brokers and franchisors provide a panel of lenders from which to choose a loan that is appropriate for the borrower. They also provide technology, marketing and administration services in return for a portion of the remuneration paid by lenders. The scale and purchasing power of wholesale mortgage broking groups and franchisors means that they are able to offer their mortgage brokers competitive rates and a large selection of products.

Brokers affiliated with AFG (AFG Brokers) are able to offer a range of products to borrowers, including:

- Residential mortgages
- AFG-branded mortgages
- Commercial mortgages
- Equipment and leasing finance
- Personal loans
- Insurance products
How does AFG generate income?

AFG generates most of its income through commissions received from lenders for the origination of loan products.

The majority of commissions received by AFG from lenders comprise two key components:

- Upfront commission: received from lenders paid as a percentage of the loan amount settled; and
- Trail commission: received from lenders over the life of the loan, paid as a percentage of the particular loan’s outstanding balance.

AFG also receives income on its own branded AFG Home Loan products in the form of fees for services provided to borrowers and a net interest margin on securitised loans, being the difference between the interest rate charged to the borrower on a loan and the cost of funding the loan.

AFG also generates income upon origination of financial products such as insurance and leasing products, which is a passive but growing income stream.

What is AFG’s growth strategy?

AFG’s strategic priorities in terms of growth are as follows:

- Protecting and growing the core residential mortgage broking business through underlying growth in the mortgage market and continued mortgage broker recruitment;
- Growing the commercial mortgage broking business;
- Increasing the penetration of the AFG Home Loans branded white label products which generate greater margins;
- Leveraging AFG’s technology investment;
- Expanding the leasing offer to help AFG Brokers and AFG grow their respective businesses; and
- Pursuing initiatives for growth via the online channel.

Wholesale broking business

AFG Broker network

AFG Broker numbers totalled over 2,650 at 30 June 2016. As can be seen from the following chart, AFG’s revenue is strongly correlated to AFG Broker numbers.
AFG Broker numbers increased by ~250 from end-FY14 to end-FY16, and we expect broker numbers to increase by 125 per annum over our forecast period.

AFG has nationwide distribution with contracted AFG Brokers in all Australian states and territories and in both urban and regional markets. However, given that AFG is a WA-based company, it does have an overweight presence in WA as can be seen from the following chart.

![AFG residential mortgage book and AFG Broker numbers by state at 30 June 2014](image)

The Company has said that it is not materially exposed to the success or performance of any one AFG Member or AFG Broker. The largest AFG Member accounted for 12% of AFG’s brokers by number in FY14 but only 6% of FY14 settlements and less than 4% of the upfront commissions retained by AFG during FY14. Unfortunately, AFG has not provided an update on these statistics.

As can be seen from the following chart, the top 50 AFG brokers accounted for less than 15% of the total number of settlements in FY14, down from 17% in FY12.
AFG Broker value proposition

AFG believes that its mutually beneficial relationship with AFG Brokers is a key feature of AFG’s success. Except in limited circumstances, AFG Brokers are contracted to exclusively originate mortgage products of the AFG Lending Panel (including AFG Home Loans).

AFG adds value to its brokers in the following ways:

- **Scale efficiencies:** The size of AFG’s loan book attracts new mortgage brokers, who in turn originate more loans and revenues. The size of the loan book also delivers improved efficiencies in supplying support functions.

- **Technology platform:** A major component of AFG’s support is delivered through its platform called FLEX, representing AFG’s investment in the latest IT systems. AFG also manages SMART, a custom-built marketing program and CRM, on behalf of its mortgage brokers.

- **Access to a diverse lending panel:** AFG provides access to a diverse panel of over 45 lenders, including each of the four major banks.

- **Greater mortgage broker buying power:** As one of the largest mortgage broking groups in Australia, AFG generates a significant quantity of loans for lenders, placing it in a strong position to negotiate preferred origination terms and conditions. AFG’s market share means it is relevant to most financial institutions operating in Australia that seek to distribute mortgage products.

- **Business development and sales support**

- **Administration and support systems**

- **Compliance:** AFG Brokers can apply to become AFG Credit Representatives under AFG’s ACL or operate under their own ACL. In either case, AFG Brokers are offered support by AFG’s national compliance team such as access to online training and education resources.

- **Not owned or controlled by a bank:** With some of its competitors now owned or controlled by the major banks, AFG claims that its separate ownership provides a benefit to AFG Brokers by offering them a level of independence which may not be available to mortgage brokers aligned with a wholesale mortgage broker that is owned by a bank.

- **Emerging business development initiatives:** The Company has said that new business growth initiatives for AFG Brokers will be available as AFG broadens its finance offering. A greater share of margin from each customer relationship will potentially be available to AFG and AFG Brokers as a consequence.
**Competition**

AFG directly competes with other wholesale mortgage brokers and franchised mortgage broking groups. All these wholesale mortgage businesses provide various levels of technology, back office and administration functions, training, and lending relationships to affiliated, franchised and independent mortgage brokers.

AFG’s competitors include wholesale mortgage brokers such as Vow Financial (acquired by Yellow Brick Road in May 2014), PLAN (owned by NAB), FAST (owned by NAB) and Choice (owned by NAB), and Connective as well as franchisors such as Mortgage Choice and Aussie Home Loans (partly owned by CBA).

Through its AFG Brokers, AFG indirectly competes with other mortgage brokers and distribution networks of the various banks and other mortgage providers within the mortgage industry.

The following table sets out the different operating models within the mortgage broking industry.

<table>
<thead>
<tr>
<th>Model</th>
<th>Description</th>
<th>Examples</th>
</tr>
</thead>
<tbody>
<tr>
<td>Wholesale Mortgage Broker Model</td>
<td>Wholesale mortgage brokers secure mortgage products from their lending panel and provide the support for mortgage brokers to distribute under their own name.</td>
<td>AFG, PLAN*, Vow Financial**, Choice*, Connective, FAST*</td>
</tr>
<tr>
<td>Franchisor Model</td>
<td>A franchisor assigns franchisees the right to market and distribute the franchisor’s branded service and to use the business name for a fixed period of time.</td>
<td>Mortgage Choice, Aussie Home Loans***</td>
</tr>
<tr>
<td>Licensee Model</td>
<td>Similar to the franchise model, loan writers are employed or licensed by a single branded employer, which generally pays a mix of salary and commissions to licensees.</td>
<td>Yellow Brick Road</td>
</tr>
<tr>
<td>Sole Trader</td>
<td>The owner and broker are one and the same with no group affiliation.</td>
<td></td>
</tr>
</tbody>
</table>

*S 100% owned by NAB
**100% owned by Yellow Brick Road
***Controlled by CBA

SOURCES: MORGANS, COMPANY REPORTS.
Increasing settlements and loan book driving commission revenue

Upfront commissions

Upfront commission revenue is driven by the average upfront commission rate and settlement volumes. The following charts show that both these drivers have been increasing over the last four years.

Growth in AFG’s settlement volumes has been driven by increasing system housing settlements together with AFG increasing its market share as shown in the following chart.

Whilst the average upfront commission rate as well as settlement volumes have been increasing, the average contracted residential upfront payout ratio has been increasing to the extent that AFG’s net upfront commission rate has been decreasing as we have shown in the following table.
Figure 9: Resi upfront commission rate

<table>
<thead>
<tr>
<th></th>
<th>FY12</th>
<th>FY13</th>
<th>FY14</th>
<th>FY15*</th>
<th>FY16*</th>
</tr>
</thead>
<tbody>
<tr>
<td>Average resi upfront commission rate</td>
<td>0.54%</td>
<td>0.56%</td>
<td>0.59%</td>
<td>0.59%</td>
<td>0.59%</td>
</tr>
<tr>
<td>Average resi upfront payout ratio</td>
<td>89.42%</td>
<td>89.10%</td>
<td>90.93%</td>
<td>92.00%</td>
<td>93.00%</td>
</tr>
<tr>
<td>Net resi upfront commission rate</td>
<td>0.057%</td>
<td>0.054%</td>
<td>0.047%</td>
<td>0.041%</td>
<td></td>
</tr>
<tr>
<td>% Change</td>
<td>6.8%</td>
<td>(12.3%)</td>
<td>(11.8%)</td>
<td>(12.5%)</td>
<td></td>
</tr>
</tbody>
</table>

* Morgan’s estimates

SOURCES: MORGANS, COMPANY REPORTS

Trail commissions

Total trail commissions in any given period is a function of the average trail commission rate and the average size of the loan book in that period. While the average upfront commission rate has been increasing over the last few years, the average trail rate has been decreasing as can be seen from the following charts. However, strong growth in AFG’s total loan book is assisting trail commission revenue.

At 30 June 2016, 95% of AFG’s total book comprised of residential lending. From this perspective, it makes sense to compare AFG’s total loan book growth with system home loan growth. It can be seen from the following charts that AFG has grown its loan book at roughly twice the rate of system home loan growth over recent years.
Average contracted residential trail payout ratios have been increasing, which combined with declining headline trail commission rates have resulted in significant declines in AFG’s net trail commission rate as shown in the table below.

**Figure 14: Resi trail commission rate**

<table>
<thead>
<tr>
<th></th>
<th>FY12</th>
<th>FY13</th>
<th>FY14</th>
<th>FY15*</th>
<th>FY16*</th>
</tr>
</thead>
<tbody>
<tr>
<td>Average resi trail commission rate</td>
<td>0.19%</td>
<td>0.18%</td>
<td>0.17%</td>
<td>0.17%</td>
<td>0.17%</td>
</tr>
<tr>
<td>Average resi trail payout ratio</td>
<td>88.26%</td>
<td>88.72%</td>
<td>90.07%</td>
<td>90.50%</td>
<td>92.00%</td>
</tr>
<tr>
<td>Net resi trail commission rate</td>
<td>0.022%</td>
<td>0.020%</td>
<td>0.017%</td>
<td>0.016%</td>
<td>0.014%</td>
</tr>
<tr>
<td>% Change</td>
<td>(9.0%)</td>
<td>(16.9%)</td>
<td>(4.3%)</td>
<td>(15.8%)</td>
<td></td>
</tr>
</tbody>
</table>

**Sources:** MORGANS, COMPANY REPORTS

**Trail book accounting**

The trail commission for the purposes of the income statement in a given year is the present value of expected trail commissions from settlements in that year. In other words, AFG recognises the present value of the expected trail commission receivable upfront at the time of settlement, in accordance with Australian Accounting Standards (AAS). Such recognition involves assumptions around the average loan life and discount rate per annum.

The average life of a home loan has shortened in recent years as a result of lower interest rates (which results in high prepayments) and increased mortgage competition (which results in increased refinance activity).

**Outlook for commission revenue**

We expect system home lending growth of 6% pa over FY17, FY18 and FY19, and we expect AFG to grow its total loan book by 12% pa over this period.

Unfortunately AFG does not disclose the break-up of its total commission revenue by upfront/trail or by residential/commercial. The following chart shows total commission income as a percentage of the average loan book.

**Figure 15: Commission income (excluding PV of future trails) as % of average total loan book**

AFG shares the commission income with AFG brokers as per contracted payout ratios. The following chart shows the average upfront and trail payout ratios for the last five years.
It can be seen from the chart above that both upfront and trail payout ratios have been trending up over the last few years. We believe this has been the result of increased competition for brokers. Higher payout ratios should translate to higher broker numbers and higher settlements and this has been the case for AFG. The uptrend in payout ratios likely explains some of the increase in AFG’s settlement market share.

Increasing payout ratios and reducing trail commission rates have resulted in net commission income growth being lower than growth in settlement volumes and lower than total loan book growth as shown in the chart below.

While we expect loan book growth of 12% pa over our forecast period, we forecast annual net commission income growth to be less than this rate over the same period. We expect AFG’s broker payout ratios to continue to increase over the next couple of years to ~95% from ~93% in FY16. However, we expect the uptrend in payout ratios to level off at 95%, and this levelling off may occur quicker if increased scrutiny of the mortgage broking industry by regulators results in brokers wanting to align themselves with larger aggregators.

We do not expect commission rates offered by lenders to fall over our forecast period.
White label mortgage business

AFG Home Loans currently has wholesale funding agreements with Bendigo and Adelaide Bank, Macquarie, Pepper and Advantedge (a business line of NAB). Each agreement contains pricing and product parameters for specific white label products which are available to AFG Brokers for distribution to borrowers.

Until recently, AFG Home Loans was responsible for mortgage management of white label products funded by Bendigo and Adelaide Bank. However, this is no longer the case as AFG Home Loans’ relationship with BEN is now a pure white label product relationship with BEN taking care of the management of the loan. In fact, AFG is currently not doing any mortgage management. This change will result in a change in revenue composition going forward with mortgage management fees decreasing to zero.

The white label business is attractive for AFG as it generates ~5bps of extra upfront commission which is not shared with brokers and it generates ~10-12bps of extra trail commission which is not shared with brokers. Therefore, if AFG grows the white label products faster than other products, we would expect the average commission rate to increase with all else constant.

AFG’s white label settlements totalled $1.4bn in FY16, up from $460m in FY15. The prospectus forecast for white label settlements in FY16 was $1.30bn.

AFG Securities business

AFG Securities was established by AFG in 2007 as a securitisation funding business, with its primary role being the funding of home loans sourced by AFG Home Loans through the process of securitisation.

As a lender in its own right, AFG Securities is responsible for establishing and enforcing its own lending guidelines, policies and procedures. These guidelines, policies and procedures have been developed in line with the requirements of the warehouse providers.

For growth to be achieved in the AFG Securities loan book, conditions in the residential mortgage back securities (RMBS) market need to be conducive. Since the GFC, there have been a few periods where the RMBS market has effectively been closed to new issues due to lack of investor demand. In our view, conditions in the RMBS market have been relatively tight for most of this calendar year and if the US Federal Reserve raises the Fed Funds Rate in coming months then there is the risk that RMBS market conditions will tighten further.

The following charts show growth in the AFG Securities loan book as well as the net interest margin for this book over the last five years.

Our view is that AFG will look to keep the market share of AFG Securities very small to avoid a conflict with lenders on the AFG Lending Panel. Also, again, the AFG Securities business is effectively at the mercy of RMBS market conditions which means that it is not a business which can be consistently relied upon for growth.
Costs

AFG certainly has a scalable business model. We expect the Company to deliver positive jaws on a full-year basis over each of our forecast years as there is enough scope for further cost leverage in the business model. If the company broadens its offering to include commercial product manufacturing then this is likely to be accompanied with additional headcount in the credit assessment area, however the margins on these products are likely to be wide enough to more than compensate for the additional costs involved.

The following table shows that total expense growth (excluding capital raising costs) was 2.2% from FY15 to FY16, whilst combined growth in gross profit and other income was 10.6% over the same period.

<table>
<thead>
<tr>
<th>Figure 20: Expense growth versus income growth (A$'000)</th>
</tr>
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<tbody>
<tr>
<td><strong>Expenses:</strong></td>
</tr>
<tr>
<td>Administration expenses</td>
</tr>
<tr>
<td>Advertising and promotion</td>
</tr>
<tr>
<td>Consultancy and professional fees</td>
</tr>
<tr>
<td>Information technology</td>
</tr>
<tr>
<td>Occupancy costs</td>
</tr>
<tr>
<td>Employee costs</td>
</tr>
<tr>
<td>Depreciation and amortisation</td>
</tr>
<tr>
<td>Operating lease costs</td>
</tr>
<tr>
<td>Impairment loss/(reversal of impairment) on receivables</td>
</tr>
<tr>
<td>Net loss on disposal of property, plant and equipment</td>
</tr>
<tr>
<td>Capital raising costs</td>
</tr>
<tr>
<td><strong>Total excluding capital raising costs</strong></td>
</tr>
<tr>
<td>FY15          FY16            Change</td>
</tr>
<tr>
<td>Administration expenses</td>
</tr>
<tr>
<td>Advertising and promotion</td>
</tr>
<tr>
<td>Consultancy and professional fees</td>
</tr>
<tr>
<td>Information technology</td>
</tr>
<tr>
<td>Occupancy costs</td>
</tr>
<tr>
<td>Employee costs</td>
</tr>
<tr>
<td>Depreciation and amortisation</td>
</tr>
<tr>
<td>Operating lease costs</td>
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<tr>
<td>Impairment loss/(reversal of impairment) on receivables</td>
</tr>
<tr>
<td>Net loss on disposal of property, plant and equipment</td>
</tr>
<tr>
<td>Capital raising costs</td>
</tr>
<tr>
<td><strong>Total excluding capital raising costs</strong></td>
</tr>
</tbody>
</table>

| **Income:**                                           |
| Gross profit                                          | 51,394       55,102       7.2%         |
| Other income                                          | 12,296       15,345       24.8%        |
| **Total**                                             | 63,690       70,447       10.6%        |

AFG currently has ~190 staff, of which ~40 are in the IT area.

AFG believes it has the best mortgage aggregator platform in the market. AFG commented at its 2016 Annual General Meeting that it has completed the migration of its IT systems to the cloud. The Company expects this to result in reduced operational and maintenance costs and has said that the cost savings enables further investment in technology and innovation. We note that AFG has recently added 5 or 6 people to its IT team to purely focus on innovation. We believe a direct-to-consumer piece is one of the areas of innovation being worked on.
Dividends

AFG pointed out in its prospectus that its directors intend to target a payout ratio of between 70% and 80% of Underlying Earnings. “Underlying Earnings” is defined as AFG’s underlying after tax earnings with trail commissions being accounted for on an as received basis.

However, the Company has also pointed out that the dividend payout ratio is expected to vary between periods depending on factors which include the following:

- The general business environment.
- Operating results.
- Cash flows.
- Financial condition of AFG.
- Future funding requirements.
- Capital management initiatives.
- Taxation considerations (including the level of franking credits available).
- Business development initiatives.

In FY16, the Company announced an interim fully franked ordinary dividend of 3.0 cps and a final fully franked ordinary dividend of 5.4 cps. This equated to a full year dividend payout ratio of 80% of Underlying Earnings.

We expect Underlying Earnings growth to be enough to support 80% full year dividend payout ratios over our forecast period and we expect the dividends over this period to be fully franked. AFG’s franking credit balance was $42.66m at 30 June 2016, up from $30.95m at 30 June 2015.

AFG had cash at bank and short-term deposits totalling $85.9m at 30 June 2016, equating to cash per share of 40 cents. We do expect AFG to make acquisitions down the track for a couple of reasons: we expect industry consolidation particularly as regulators are increasingly scrutinising the industry; and fintech acquisition opportunities may arise as the industry is increasingly focussing on innovation and digital disruption.

Gearing

AFG had $1.072bn of interest-bearing liabilities on its balance sheet at 30 June 2016. $697m of this was related to securitisation warehouse facilities and $374m was related to RMBS issues. The balance of interest-bearing liabilities relates to loans from funders (some of the upfront commissions received from specific funders at the point of loan origination are refunded by the Group via reduced ongoing management fees over a period of 5 years – the Group recognises the upfront commission from these funders as a loan, and interest is charges on this facility by the funders).

Risks

Review of broker remuneration

ASIC is currently undertaking a review at the request of the Government in relation to broker remuneration structures and their effect on consumer outcomes. The report is expected to be provided to the Government by the end of this month.

The following table sets out the scope of the review, with the caveat that review parameters may shift throughout the review if ASIC considers it appropriate, necessary or in the public interest to do so.
From our perspective, one of the key objectives of the review is to look into whether existing broker remuneration results in conflicted advice. Lenders currently offer differing levels of upfront and trail commissions to brokers which creates scope for brokers to push products with higher commissions attached.

In our discussions with AFG regarding this matter AFG has said that it has a lot of data which shows that broker behaviour is driven by price and service, and is not driven by current commission structures. In other words, AFG has said that there is no significant correlation between broker remuneration and volumes.

Potential changes which may stem from this review include:

- Brokers continuing to be remunerated by lenders but the commissions structures being standardised, i.e. all lenders pay the same levels of commissions.
- Lenders not being allowed to remunerate brokers, and brokers being paid a fee for service by customers instead.

We do not expect the latter potential change to materialise as it is likely to result in reduced mortgage competition. The mortgage broking industry has been making the case that many of Australia’s smaller lenders rely on mortgage brokers to act as a distribution network for their products. The loss of the broker based distribution network would put these lenders at a major disadvantage to the large banks and result in a significant reduction in competition in the mortgage sector, to the detriment of consumers. If this potential change were to materialise, then we would expect a reduction in consumer demand for brokers due to the service fee involved.
If anything were to change, the potential for standardised commissions is more likely in our view. In our discussions with AFG regarding this matter, AFG has said that it would be fine with standardised commissions.

**Additional compliance requirements**

There is also the risk that at some point advice provided by mortgage brokers will constitute ‘financial advice’ and may result in additional licensing and compliance requirements for brokers. If this were to happen, then smaller aggregators will be more likely to suffer as they may not have sufficient scale to deal with the increased licensing and compliance burden. The downside of such a scenario for AFG would be increased licensing and compliance costs, however a potential upside can be that such a scenario may present the opportunity to acquire smaller players which will struggle to deal with the new environment.

**Other risks**

Other risks include:

- Decrease in broker penetration of home loan flows
- Significant reduction in system home lending growth.
Board of directors

Anthony (Tony) Gill, Non-executive Chairman

Mr Gill has been the Chairman of the Board since 2008. Mr Gill has extensive experience across Australia’s finance industry, including with Macquarie Bank for more than 16 years, most recently as Group Head of the Banking and Securitisation Group (BSG). Mr Gill is a director of First Mortgage Services, First American Title Insurance, Genworth Mortgage Insurance Australia Limited and sits on the board of the Butterfly Foundation for Eating Disorders and is a member of ASIC’s External Advisory Panel. Mr Gill holds a Bachelor of Commerce and is a Chartered Accountant (retired).

Brett McKeon, Managing Director and Chief Executive Officer

Mr McKeon is a founding director of the Group and is the Company’s Managing Director/Chief Executive Officer. He is responsible for the Group’s strategy, corporate governance and for driving future growth. Mr McKeon has worked for over 30 years in the finance industry and brings considerable management, capital raising, public company and sales experience to the board of AFG. Mr McKeon is a licensed finance broker and in 2006 he was awarded The Ernst & Young Entrepreneur of the Year for WA. During the past three years Mr McKeon has also served as a director of Caravel Minerals Limited (appointed in 2012; resigned in 2015).

Malcolm Watkins, Executive Director

Mr Watkins is a founding director of the Group. He holds strategic responsibility for the Group’s technology development programs, electronic delivery systems and national marketing operations. Mr Watkins’ key focus is extracting real and tangible returns on the investments made and leveraging the strengths of the Group today to further expand market share, profitability and brand awareness. Mr Watkins has recently been appointed to the board of the Mortgage and Finance Association of Australia (MFAA).

Kevin Matthews, Non-executive Director

Mr Matthews is a founding director of the Group. He previously held a role as an Executive Director and was responsible for negotiating and managing key relationships with banks and lending institutions, including product development and the Commercial line of business. Mr Matthews ceased to be an Executive Director and became a non-executive director on 1 May 2015. Mr Matthews has worked in the finance industry for more than 35 years and has been a licensed finance broker for more than 25 years. He is a former director of the Mortgage and Finance Association of Australia (MFAA) and served on the MFAA’s National Brokers Committee for 12 years. Mr Matthews is also a Senior Fellow of the Financial Services Institute of Australasia (FINSIA) and a life member of the MFAA.

James (Jim) Minto, Independent Non-executive Director

Mr Minto rejoined the AFG Board in 2015 following his retirement as Group CEO and Managing Director of life insurer TAL (formerly TOWER Australia). TAL is 100% owned by Dai-ichi Life, a major global Japanese-based life insurer. Mr Minto had been in that role since November 2006 and prior to that was Group CEO of the Trans-Tasman TOWER Limited Group. Mr Minto has extensive experience in the financial services sector and an intimate understanding of the AFG business, having previously been a member of the AFG board from 2004 until 2013. Mr Minto is the Chairman of the Remuneration and Nomination committee. A Chartered Accountant, Mr Minto recently retired as Chair of the Association of Superannuation Funds of
Australia (ASFA) and was a panel member of the Australian Government’s 2011 Review of Natural Disasters Insurance. He is also an executive officer of Dai-ichi Life of Japan, a director of Singapore-based Dai-ichi Life Asia Pacific. Mr Minto is a Fellow Chartered Accountant (FCA) with Chartered Accountants Australia and New Zealand. He is also a member and Graduate of the Australian Institute of Company Directors.

Craig Carter, Independent Non-executive Director

Mr Carter has 35 years of experience in stockbroking, capital markets and corporate finance. Most recently Mr Carter was Chairman and Executive Director of Macquarie Capital in Western Australia and currently has a diverse range of business interests. Mr Carter has been involved in many capital raisings including initial public offerings across many industry groups. Mr Carter is the Chairman of the Audit Committee and of the Risk and Compliance Committee. Mr Carter is also currently a Board member of the Fremantle Football Club. Mr Carter holds a Bachelor of Business and is a Fellow of FINSIA.

Melanie Kiely, Independent Non-executive Director

Ms Kiely is an experienced executive and company director with over 25 years of experience in health care, financial services and consulting in Australia, Europe and South Africa. Ms Kiely commenced with Silver Chain in the role of Executive General Manager, Social Care, in November 2015. She is currently a Director of the Black Dog Institute and Intework. Prior to this, Ms Kiely was the Executive General Manager Strategy, Risk and HealthGuard, at HBF Health Fund. Prior to joining HBF, Ms Kiely held senior roles with nib health funds, MBF and Accenture and has also held a number of Board positions in the financial services and health sectors. Ms Kiely has an Honours Degree in Business Science from the University of Cape Town and is a Graduate of the Australian Institute of Company Directors. Ms Kiely joined the AFG Board as a Non-Executive Director in March 2016.

Jane Muirsmith, Independent Non-executive Director

Ms Muirsmith is an accomplished digital, channel and marketing strategist with a proven track record of helping companies leverage digital technologies to drive innovation and business outcomes. She has broad experience spanning 25 years across many industries including financial services, insurance, utilities, Government, professional services, retail, manufacturing and technology. Ms Muirsmith is Managing Director of Lenox Hill, a digital strategy and consulting company and is a Non-Executive Director of Healthdirect Australia. She is also a member of the Ambassadorial Council UWA Business School and sits on the AIM UWA Business School Executive Education board. She is a Fellow with Chartered Accountants Australia and New Zealand, where she is Vice Chairman of the WA Business Advisory Committee and is a Graduate of the Australian Institute of Company Directors. Ms Muirsmith was appointed to the AFG Board as a Non-Executive Director in March 2016.
## Figure 22: AFG financial summary

### FINANCIAL SUMMARY

<table>
<thead>
<tr>
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</thead>
<tbody>
<tr>
<td>Rep. NPAT ($'000)</td>
<td>20,379</td>
<td>22,667</td>
<td>25,276</td>
<td>27,903</td>
<td>30,967</td>
</tr>
<tr>
<td>Profit from continuing operations</td>
<td>15,296</td>
<td>22,644</td>
<td>25,253</td>
<td>27,880</td>
<td>30,944</td>
</tr>
<tr>
<td>No. shares ('000)</td>
<td>214,812</td>
<td>214,812</td>
<td>214,812</td>
<td>214,812</td>
<td>214,812</td>
</tr>
<tr>
<td>Avg # of shares ('000)</td>
<td>214,813</td>
<td>214,813</td>
<td>214,813</td>
<td>214,813</td>
<td>214,813</td>
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<tr>
<td>EPS - continuing operations ($)</td>
<td>0.0712</td>
<td>0.1054</td>
<td>0.1176</td>
<td>0.1298</td>
<td>0.1440</td>
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<tr>
<td>EPS (continuing operations) growth (%)</td>
<td>48%</td>
<td>12%</td>
<td>10%</td>
<td>11%</td>
<td>11%</td>
</tr>
<tr>
<td>PER (x)</td>
<td>16.9</td>
<td>11.4</td>
<td>10.2</td>
<td>9.2</td>
<td>8.3</td>
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<tr>
<td>DPS ($)</td>
<td>n/a</td>
<td>0.084</td>
<td>0.093</td>
<td>0.103</td>
<td>0.114</td>
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<tr>
<td>Payout ratio (% of Underlying Earnings)</td>
<td>n/a</td>
<td>80%</td>
<td>80%</td>
<td>80%</td>
<td>80%</td>
</tr>
<tr>
<td>Div Yld (%)</td>
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<td>7.0%</td>
<td>7.8%</td>
<td>8.6%</td>
<td>9.5%</td>
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<tr>
<td>Franking (%)</td>
<td>n/a</td>
<td>100%</td>
<td>100%</td>
<td>100%</td>
<td>100%</td>
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<tr>
<td>NTA ($'000)</td>
<td>71,366</td>
<td>87,787</td>
<td>153,462</td>
<td>207,350</td>
<td>264,857</td>
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<tr>
<td>NTA per share ($)</td>
<td>0.33</td>
<td>0.41</td>
<td>0.71</td>
<td>0.97</td>
<td>1.23</td>
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<td>Price to NTA ps (x)</td>
<td>3.6</td>
<td>2.9</td>
<td>1.7</td>
<td>1.2</td>
<td>1.0</td>
</tr>
<tr>
<td>RoNTA (NPAT / open NTA)</td>
<td>32%</td>
<td>29%</td>
<td>18%</td>
<td>15%</td>
<td>15%</td>
</tr>
<tr>
<td>Book ROE (NPAT / avg ord equity)</td>
<td>31%</td>
<td>29%</td>
<td>18%</td>
<td>15%</td>
<td>15%</td>
</tr>
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### INCOME STATEMENT ($'000)

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<tbody>
<tr>
<td>Commission and other income</td>
<td>462,820</td>
<td>482,331</td>
<td>540,081</td>
<td>601,532</td>
<td>672,707</td>
</tr>
<tr>
<td>Securitisation interest income</td>
<td>48,534</td>
<td>46,597</td>
<td>43,427</td>
<td>44,739</td>
<td>46,092</td>
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<tr>
<td>Operating income</td>
<td>511,354</td>
<td>528,928</td>
<td>583,508</td>
<td>646,272</td>
<td>718,796</td>
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<tr>
<td>Comission and other cost of sales</td>
<td>-421,324</td>
<td>-440,790</td>
<td>-495,816</td>
<td>-553,810</td>
<td>-620,441</td>
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<tr>
<td>Securitisation interest expense</td>
<td>-38,096</td>
<td>-33,036</td>
<td>-29,657</td>
<td>-30,554</td>
<td>-31,477</td>
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<tr>
<td>Gross profit</td>
<td>51,934</td>
<td>55,102</td>
<td>58,035</td>
<td>58,908</td>
<td>54,319</td>
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<tr>
<td>Other income</td>
<td>12,296</td>
<td>15,345</td>
<td>16,112</td>
<td>16,918</td>
<td>17,764</td>
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<td>Administration expenses</td>
<td>-3,209</td>
<td>-3,314</td>
<td>-3,480</td>
<td>-3,654</td>
<td>-3,836</td>
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<td>Other expenses</td>
<td>-41,757</td>
<td>-36,881</td>
<td>-37,597</td>
<td>-38,327</td>
<td>-39,071</td>
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<tr>
<td>Results from operating activities</td>
<td>19,264</td>
<td>30,252</td>
<td>33,071</td>
<td>36,845</td>
<td>41,737</td>
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<tr>
<td>Net finance income</td>
<td>2,462</td>
<td>2,674</td>
<td>3,005</td>
<td>2,984</td>
<td>2,468</td>
</tr>
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<td>PBT from continuing operations</td>
<td>21,726</td>
<td>32,926</td>
<td>36,075</td>
<td>39,829</td>
<td>44,205</td>
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<td>Income tax expense</td>
<td>-6,430</td>
<td>-10,282</td>
<td>-10,823</td>
<td>-11,949</td>
<td>-13,262</td>
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<tr>
<td>Profit from continuing operations</td>
<td>15,296</td>
<td>22,644</td>
<td>25,253</td>
<td>27,880</td>
<td>30,944</td>
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<tr>
<td>Profit after tax from discontinued operations</td>
<td>5,078</td>
<td>0</td>
<td>0</td>
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<tr>
<td>Non-controlling interests</td>
<td>5</td>
<td>23</td>
<td>23</td>
<td>23</td>
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<tr>
<td>Reported NPAT</td>
<td>20,379</td>
<td>22,667</td>
<td>25,276</td>
<td>27,903</td>
<td>30,967</td>
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### GROWTH RATES

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<tr>
<td>Total loan book growth</td>
<td>15%</td>
<td>13%</td>
<td>12%</td>
<td>12%</td>
<td>12%</td>
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<tr>
<td>AFG Securities loan book growth</td>
<td>1%</td>
<td>2%</td>
<td>3%</td>
<td>3%</td>
<td>3%</td>
</tr>
<tr>
<td>Net commission income growth</td>
<td>9%</td>
<td>0%</td>
<td>8%</td>
<td>8%</td>
<td>10%</td>
</tr>
<tr>
<td>Growth in gross profit and other income</td>
<td>8%</td>
<td>10%</td>
<td>5%</td>
<td>6%</td>
<td>7%</td>
</tr>
<tr>
<td>Expense growth</td>
<td>19%</td>
<td>-11%</td>
<td>2%</td>
<td>2%</td>
<td>2%</td>
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Stocks under coverage


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