

Company Review

Ord Minnett Research

Thursday May 1, 2008

DKN Financial Group Limited

Market correction induces downgrade

- As confession season kicks off, DKN has bitten the bullet and announced a 10% downgrade to 2H08 NPAT to \$5.3m. DKN has cited a poor equities market in the 3Q08, which resulted in a 10% decline in FUA, as the catalyst. This is despite maintaining positive, albeit, reduced fund inflows over the period. The result is a 7% reduction to expected FY08 earnings
- OML has also taken the opportunity to cut our FUA assumptions for FY09 & FY10 by ~10% and ~12% respectively. This more conservative approach has led to a ~14% & ~17% reduction in expected EPS. Yet OML still expects double digit growth in each of the next two years. This will not be sufficient to compensate for the dilutive impact of the Lonsdale deal particularly on ROE
- Trading multiples continue to be attractive at <10x, as DKN has more than halved from its peak just before markets began correcting last August. DKN is now trading on a forward yield of ~10% fully franked. DKN is trading at a discount to peers and ~30% discount to market when in fact its close ties to the mandated growth in superannuation should see the stock trade at a premium
- OML has cut its DCF valuation aggressively by ~31% to \$1.72, the second significant downgrade since the Lonsdale acquisition, and yet the stock is still trading at a massive discount, indicating how unloved this sector is at present
- Notwithstanding that DKN 's stock price has had a disappointing year, the expected \$0.9b in fund inflow, or ~10% of FUA, highlights the strength of the distribution capacity. It is DKN's distribution power and valuation that remain positive factors in our BUY recommendation.

Key Financials

Year-end June (A\$)	FY07	FY08F	FY09F	FY10F
NPAT (\$m)	4.9	6.8	13.0	15.6
EPS (¢)	7.3	6.3	9.0	10.8
P/E (x)	10.9	12.8	8.9	7.4
EV / EBITDA (x)	8.7	9.0	6.2	4.9
DPS (¢)	6.0	4.5	7.6	9.2
Net Yield (%)	7.5	5.6	9.5	11.4
Franking (%)	100	100	100	100
Normalised NPAT (\$m)	4.9	8.9	13.0	15.6
Normalised EPS (¢)	6.8	7.2	8.2	9.8
EPS Growth (%)	13.9	5.9	12.9	19.9
Normalised P/E (x)	11.7	11.1	9.8	8.2

Source: Iress, Company, Ord Minnett Estimates. Note: Price data as at 30/4/08

ASX \$0.80

Recommendation
BUY
Risk Assessment
Medium

Diversified Financial Services

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DKN Financial Group Limited

ASX Code	DKN
52 week range	\$0.78 - \$1.97
Market Cap	\$121m
Shares Outstanding	144.4m
Av Turnover (3 month)	3.0m
NTA FY07	\$0.15
Net Debt FY07 (m)	A\$-3.9m



Fund inflows can't stop market impact

As flagged at the time of the 1H08 results, there was downside earnings risk to DKN should the market sell-off continue. As confession season has begun a few weeks early this year, DKN has released new market guidance on FY08 earnings expectations following a poor 3Q in the local and international equities markets.

This latest guidance represents the second downgrade from the company since the Lonsdale acquisition. Forecast NPAT for 2H08 has now been reduced twice by a total of \$1.0m from \$6.3m to \$5.3m, representing a ~16% downgrade.

While market conditions are not within management's control, the timing of the Lonsdale acquisition has proven to be at the top of the market. Despite the strategic value that Lonsdale provides, the level of dilution in the deal structure is exacerbated by poor equity market conditions, something that DKN could have done without!

Although the market has recovered by over 4% in April, and may continue to recover for the balance of FY08, the short time frame to June 30, does not allow the fee base to recover sufficiently to offset the impact of the significant decline in market values over the first 9 months of FY08.

Key Highlights

- The 16% fall in local equities over the 3Q08 has led to a 10% decline in DKN's FUA to \$8.1b
- DKN revealed the asset allocation of its BT platform assets which showed that asset allocation was not at the conservative end of the range for balanced funds as was expected. Asset allocation included 45% to Australian shares, 20% to International equities, 8% to property, 15% to cash / fixed interest and 12% to Structured products and Hedge funds
- Fund flows also slowed in 3Q08 from the average of \$270m per quarter in 1H08 to only \$141m. The 3Q is seasonally weak because of summer holidays and the timing of Easter, yet there has been a noticeable drop off because of market conditions
- DKN are still banking on inflows of \$230m in 4Q08, a typically strong quarter which would see total inflows at ~\$900m for the year, and a solid platform going into the first full year of operation post Lonsdale

Table 1: Funds Under Administration (FUA)

	FY06 \$b	1H07 \$b	FY07 \$b	1H08 \$b	3Q08 \$b	% change	FY08F \$b
Platform Providers							
AWM	1.27	1.37	1.48	1.43	1.26	-11.9%	1.32
BT	0.80	1.01	5.55	5.57	5.00	-10.2%	5.18
Other	0.14	0.17	0.45	0.50	0.45	-10.6%	0.45
Platform Sub-total	2.21	2.55	7.48	7.50	6.71	-10.5%	6.95
Product							
Investment Managers	0.35	0.34	1.43	1.50	1.41		
Product Sub-total	0.35	0.34	1.43	1.50	1.41	-5.9%	1.41
Total FUA	2.55	2.89	8.91	9.00	8.12	-9.8%	8.36
Period Net Inflows	na	0.15	na	0.54	0.14		0.91

Source: DKN, OML

- Resulting from the decline in FUA through the 3Q08 and the lack of time for any market recovery to have an impact in FY08, OML has downgraded its FUA assumption for FY08 by ~7% to \$8.4b. We are only factoring in expected fund flows for 4Q08 and no market recovery from March levels despite one having commenced in April
- This has led to a ~7% reduction in Normalised NPAT and a 10% reduction in 2H08 dividend assumption to 3.5 cps
- DKN have guided the market on their cost / income ratio at 42% - 45%, although on our forecasts it is more like 48.5%. OML is no longer forecasting a 40% cost / income ratio until FY10

Table 2: Earnings Revisions

	Previous FY08F	Revised FY08F		Previous FY09F	Revised FY09F		Previous FY10F	Revised FY10F	
	\$m	\$m	% change	\$m	\$m	% change	\$m	\$m	% change
FUA (\$b)	9.0	8.4	-6.7%	11.0	10.0	-9.5%	13.4	11.8	-11.9%
Operating Revenue	24.6	23.7	-3.8%	34.4	31.6	-8.2%	41.5	37.3	-10.1%
EBITDA	13.1	12.2	-6.9%	20.5	17.7	-13.3%	26.3	22.3	-15.3%
EBIT	13.1	12.2	-6.9%	20.4	17.7	-13.4%	26.2	22.2	-15.3%
NPBT	13.0	12.1	-7.0%	20.4	17.7	-13.4%	25.2	21.2	-16.1%
Reported NPAT	7.5	6.8	-9.0%	15.0	13.0	-13.4%	18.5	15.6	-16.1%
Normalised NPAT	9.6	8.9	-7.0%	15.0	13.0	-13.4%	18.5	15.6	-16.1%
Basic EPS (cps)	7.0	6.3	-9.9%	10.5	9.0	-14.7%	13.0	10.8	-17.3%
Normalised EPS (cps)	7.8	7.2	-7.8%	9.5	8.2	-14.6%	11.8	9.8	-17.2%
EPS Growth (%)	14.9%	5.9%		21.9%	12.9%		23.7%	19.9%	
DPS	5.0	4.5	-9.9%	8.6	7.6	-11.6%	11.7	9.2	-21.9%
EBITDA Margin	53.4%	51.7%		59.5%	56.1%		63.4%	59.8%	
ROE	4.8%	4.4%		9.5%	8.2%		11.6%	9.7%	

Source: DKN, OML

OML has also revised its forecasts for FY09 – FY10:

- We have assumed DKN can maintain its organic inflows and increase them to ~\$1b pa
- We are assuming market growth of ~5% - 6% pa. We suggest this is sufficiently conservative if there is a sustained recovery and limits any further downside if the recovery flounders
- While this results in a downgrade of FUA forecasts of 9.5% and ~12%, actual forecasts still factor in 19% and 18% growth respectively
- EPS forecasts are cut by ~14% and ~17% respectively, but still leave DKN generating double digit growth in FY09, the first full year of DKN, incorporating Lonsdale, and superior growth in FY10
- While the dividend has been cut by ~12% in FY09 and ~22% in FY10, the stock is still yielding 9.5% and 11.4% fully franked. At some point when markets stabilise and the wealth management sector emerges into the sunlight, such yields should prove highly appealing

Valuation - \$1.72, still more than double!

In addition to OML taking the knife to medium term earnings forecasts, OML has aggressively increased its WACC to account for increased market risks.

We have increased the WACC from 11.4% to 13.2% which accounts for \$0.50 of the \$0.78 (31%) decline in OML's valuation.

DKN is trading on <10x FY09F earnings which have been revised down 14% and is yielding ~10% fully franked. It is quite appealing.

DKN has experienced one of the more significant declines in the sector. DKN is trading at a discount to market of ~30% when typically in a stable market it has traded at a premium. This is the opportunity for investors, notwithstanding the depressing short-term atmosphere.

Yet DKN is being weighed down by the dilution from the Lonsdale acquisition, despite not having owned the business for long. The FY07 result highlighted DKN's ROE at ~11% (pre-Lonsdale) with a market expectation that ROE would continue to appreciate to a superior level on organic earnings growth, effectively becoming another COU.

At a peak of \$1.88 DKN was valued at ~\$130m. Despite having made a \$120m purchase of Lonsdale, the merged group is now valued at \$115m. So the market has attributed no value to a business that has significant strategic value to DKN and should propel superior earnings growth over the long-term.

While DKN believed it was necessary to pay a peer group multiple to get the deal over the line, this has clearly proved to be too high, at least in the short term.

DKN's expected ROE in FY08 is ~4%, but even with a full year of Lonsdale, DKN's forecast ROE in FY09 is still only 8.2%, down from the previous forecast of 9.5%. In fact OML does not forecast DKN's ROE to exceed its current WACC until FY12. This could be too long to wait for DKN to deliver excess returns on capital deployed. DKN would have to achieve vastly superior growth to current expectations to expedite a more satisfactory ROE outcome.

Given that ROE is in a relatively poor state, it does not leave DKN much flexibility on the acquisition front. OML suggests that DKN focus on delivering superior organic growth rather than chase acquisitions that are dilutive to existing shareholders.

DKN has built an exceptional distribution capacity from the non-aligned financial planning sector that offers strong organic growth opportunities. It is for this reason and the trading metrics that we retain a positive view on the stock despite the poor state of return on capital.

Table 3: Peer Group Comparison

Stock	Code	Share price	Market Cap \$m	EBITDA (x)		PE (x)		EPSG (%)		Yield (%)	
				FY08F	FY09F	FY08F	FY09F	FY08F	FY09F	FY08F	FY09F
Australian Wealth Management	AUW	\$1.81	1,022.1	8.1	7.0	12.5	10.8	35.6	15.3	6.6	7.7
Count Financial	COU	\$2.18	521.8	12.3	10.2	19.5	16.2	17.9	20.1	4.6	5.1
WHK Group	WHG	\$1.38	352.9	6.5	5.3	10.2	8.9	23.4	14.2	4.7	5.3
Plan B Group Holdings Limited	PLB	\$0.90	67.5	8.5	7.7	12.5	11.4	-5.1	10.0	4.8	5.3
DKN Group	DKN	\$0.80	115.0	9.2	6.3	11.1	9.8	5.9	12.9	5.6	9.5
Peer Average				8.9	7.3	13.1	11.4	15.5	14.5	5.3	6.6
Peer Median				8.5	7.0	12.5	10.8	17.9	14.2	4.8	5.3

Source: IRESS, OML

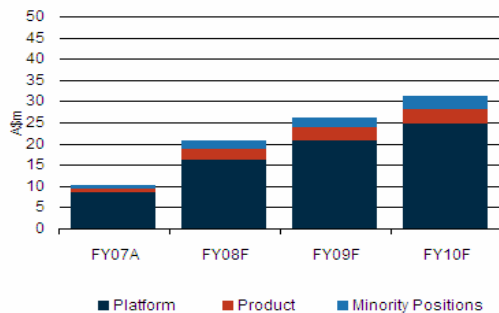
Financial Summary

DKN Financial Group

Profit & Loss Statement (A\$m)	FY07A	FY08F	FY09F	FY10F
FUA (\$b)	3.4	8.4	10.0	11.8
Operating Revenue	10.6	23.7	31.6	37.3
Operating Costs	4.4	11.4	13.8	15.0
EBITDA	6.1	12.2	17.7	22.3
Depreciation & Amortisation (Tangible)	0.0	0.0	0.1	0.1
EBITA	6.1	12.2	17.7	22.2
Amortisation	0.0	0.0	0.0	0.0
EBIT	6.1	12.2	17.7	22.2
Net Interest Expense	0.5	-0.1	0.0	-1.0
Reported Pre-Tax Profit	6.6	12.1	17.7	21.2
Tax Expense	1.7	3.1	4.7	5.6
Minority Interests	0.0	0.0	0.0	0.0
NPAT	4.9	8.9	13.0	15.6
Significant Items (After Tax)	0.0	-2.1	0.0	0.0
Reported NPAT	4.9	6.8	13.0	15.6
Normalised NPAT	4.9	8.9	13.0	15.6
EBITDA Margin	57.9%	51.7%	56.1%	59.8%
Effective tax rate	25.9%	26.0%	26.6%	26.6%
Reported EPS (c)	7.3	6.3	9.0	10.8
DPS (cps)	6.0	4.5	7.6	9.2
Yield	7.5%	5.6%	9.5%	11.4%
Payout Ratio	82.1%	72.0%	85.0%	85.0%
Franking	100%	100%	100%	100%

Cash Flow Statement (A\$m)	FY07A	FY08F	FY09F	FY10F
EBITDA	6.1	12.2	17.7	22.3
Change in Working Capital	0.1	2.2	2.0	1.6
Net Interest (paid)/received	0.5	-0.1	0.0	-1.0
Tax Paid	-0.6	-3.1	-4.7	-5.6
Other Operating Items	-3.1	0.0	0.0	0.0
Operating Cash Flow	3.1	11.2	15.0	17.3
Asset Sale Proceeds	0.0	0.0	0.0	0.0
Net Acquisitions	0.0	-120.8	0.0	0.0
Capex	0.0	-0.2	-0.3	-0.4
Other investing items	-3.3	-2.0	0.0	-1.0
Investing Cash Flow	-3.4	-123.0	-0.3	-1.4
Inc/(Dec) in Equity	0.6	108.5	0.0	0.0
Inc/(Dec) in Borrowings	0.0	31.8	0.0	0.0
Dividends Paid	-2.7	-6.5	-11.0	-13.2
Other Financing Items	0.0	0.0	0.0	0.0
Financing Cash Flow	-2.1	133.7	-11.0	-13.2
Net Inc/(Dec) in Cash	-2.4	21.9	3.7	2.7

Balance Sheet (A\$m)	FY07A	FY08F	FY09F	FY10F
Cash	3.1	25.0	28.7	31.4
Inventories	0.0	0.0	0.0	0.0
Loans & Receivables	1.4	2.6	3.1	3.4
Other Current Assets	0.1	0.1	0.1	0.1
PP & E	0.1	0.3	0.6	0.9
Intangibles	31.1	151.9	151.9	151.9
Other Non Current Assets	11.5	13.6	13.6	14.5
Total Assets	47.2	193.4	197.8	202.1
Short term Debt	0.0	0.0	0.0	0.0
Other Current Liabilities	2.2	4.7	7.1	9.1
Long term Debt	0.0	31.8	31.8	31.8
Other Non Current Liabilities	0.4	1.3	1.3	1.3
Non Current Liabilities	0.4	33.0	33.0	33.0
Total Liabilities	2.6	37.7	40.1	42.1
Total Equity	44.7	155.6	157.5	159.9
Total Liability & Shareholder Equity	47.2	193.3	197.7	202.0
Net Debt	-3.1	6.8	3.1	0.4



Source: Ord Minnett Estimates, Company Dat

Profitability Ratios	FY07A	FY08F	FY09F	FY10F
FUA Growth	33.8%	144.7%	19.0%	18.2%
Revenue Growth	17.1%	125.7%	33.4%	18.1%
EBITDA Margin	58.5%	51.7%	56.1%	59.8%
EBITDA Growth	20.8%	99.5%	44.9%	25.8%
EBITA Margin	58.1%	51.5%	56.0%	59.5%
EBITA Growth	21.0%	100.1%	45.0%	25.6%
EBIT Margin	58.1%	51.5%	56.0%	59.5%
EBIT Growth	21.0%	100.1%	45.0%	25.6%
Net Profit Margin	46.6%	28.9%	41.1%	41.7%
Net Profit Growth	14.7%	39.8%	89.7%	19.9%

DuPont Analysis	FY07A	FY08F	FY09F	FY10F
EBT Margin	57.5%	51.5%	56.0%	59.5%
x Asset Turnover	0.22	0.12	0.16	0.18
x Interest Burden	1.08	0.99	1.00	0.95
x Tax Burden	0.75	0.57	0.73	0.73
= Return on Assets	10.5%	3.5%	6.6%	7.7%
x Leverage	1.1	1.2	1.3	1.3
= Return on Equity	11.1%	4.4%	8.2%	9.7%

Per Share Ratios (A\$ cents)	FY07A	FY08F	FY09F	FY10F
EPS Normalised	6.8	7.2	8.2	9.8
EPS Growth (%)	13.9%	5.9%	12.9%	19.9%
Dividend Per Share	6.0	4.5	7.6	9.2
Cash Flow Per Share	4.6	10.3	10.4	12.0
NTA per share	20.4	3.6	4.0	5.7

Valuation Ratios (x)	FY07A	FY08F	FY09F	FY10F
Normalised P/E Multiple	11.7	11.1	9.8	8.2
Price To Book Value	3.9	22.5	19.8	14.2
Price To Cash Flow	17.4	7.8	7.7	6.7
EV / EBITDA Multiple	8.7	9.0	6.2	4.9
EV / EBITA Multiple	8.8	9.0	6.2	5.0
EV / EBIT Multiple	8.8	9.0	6.2	5.0

Leverage	FY07A	FY08F	FY09F	FY10F
Net Debt / Total Equity	-6.9%	4.3%	2.0%	0.2%
Net Debt / Total Assets	-6.5%	3.5%	1.6%	0.2%
Net Debt / (Net Debt + Mkt. Cap.)	-5.7%	6.1%	2.8%	0.3%
Interest Cover (x)	12.0	-108.5	-2352.9	-22.0

Substantial Shareholders	m. Current (%)	
Zurich Financial Services	44.0	31.0
Select Managed Funds	26.0	18.0
Remainder of Top 20	44.0	31.0

Valuation		
WACC (%)	13.2%	
Fully Diluted Number of shares (m)	156.6	
Cost of Equity	14.0%	
D/EV	10.0%	
Risk Free Rate	7.5%	
	A\$m	A\$
Operational NPV (5 year Forecast)	68.4	43.7
Terminal Value	207.2	132.3
Net Debt	6.8	4.3
Franking Credits Value (50%)	0.0	0.0
Group NPV	268.9	1.72
Current Share Price	0.80	
NPV Prem/(Disc) to Share Price	115.0%	

Sensitivity Analysis		WACC				
		12.2%	12.6%	13.2%	13.9%	14.2%
Terminal Growth Rate	4.0%	\$1.43	\$1.51	\$1.56	\$1.58	\$1.65
	4.5%	\$1.51	\$1.59	\$1.64	\$1.65	\$1.72
	5.0%	\$1.59	\$1.68	\$1.72	\$1.73	\$1.80
	5.5%	\$1.69	\$1.78	\$1.81	\$1.82	\$1.90
	6.0%	\$1.80	\$1.89	\$1.91	\$1.92	\$2.00
		b				
Equity Risk Premium	5.2%	\$2.16	\$2.09	\$2.02	\$1.95	\$1.89
	5.9%	\$2.00	\$1.92	\$1.85	\$1.79	\$1.73
	6.5%	\$1.85	\$1.78	\$1.72	\$1.66	\$1.60
	7.2%	\$1.73	\$1.66	\$1.60	\$1.54	\$1.48
	7.8%	\$1.62	\$1.55	\$1.49	\$1.44	\$1.38

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Guide to Ord Minnett Recommendations

BUY	The stock's total return (nominal dividend yield plus capital appreciation) is expected to exceed 15% over 12 months.
ACCUMULATE	The stock's total return is expected to be between 5% and 15%. Investors may add to existing holdings, or initiate holdings on share price weakness.
HOLD	The stock is fairly priced, and its total return is expected to be between 0% and 5%.
LIGHTEN	The stock's total return is expected to be less than 0% and possibly down 15%. Investors should consider selling into share price strength.
SELL	The stock's total return is expected to lose 15% or more.
RISK ASSESSMENT	Classified as High, Medium or Low, denotes the relative assessment of an individual stock's risk based on an appraisal of its disclosed financial information, volatility, nature of its operations and other relevant quantitative and qualitative criteria.

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