

INDUSTRIAL ALLIANCE INSURANCE (IAG - \$36.70)

Recommendation

BUY

Risk

Low

Target Price

\$41.00

Price

\$36.70

52-Week Range

\$34.25 - \$43.75

% Below High

-16.1%

% Above Low

7.7%

Shares O/S

80 million

Market Cap

\$2.9 billion

Average Daily Volume

201,624

Year-End

December 31

C\$	EPS	Multi.
2007A	\$3.08	11.9x
2008E	\$3.40	10.8x
2009E	\$3.70	9.9x
Book Value	\$20.98	1.8x

	Amount	Yield
Dividend	\$0.90	2.4%

Analysts

Robin Cornwell



Data Source: www.BigCharts.com

STRONG Q4/07 EARNINGS –DIVIDEND INCREASED BY 25% REDUCED STRAIN & STRONG INSURANCE SALES AN ACQUISITION LIKELY NEEDED TO MAINTAIN GROWTH

CONCLUSION: HOLD -12 MONTH TARGET MAINTAINED AT \$41.00

IAG reported strong operating earnings for Q4/07 ahead of our expectations by \$0.03. Adjusted EPS (fd) of \$0.78 was up 10% Y/Y. Individual insurance earnings were up 32% Y/Y driven by a significant and unexpected decrease in strain on very strong individual insurance sales in the quarter. Adjusted operating ROE in the quarter was 15.2%. The dividend per share was increased by 25% to \$0.90 annually from \$0.80, representing a payout ratio on 2007 EPS of 29% in line with IAG's target ratio.

For 2007, IAG reported operating EPS of \$3.08, an increase of 17% over \$2.64 in 2006. A recovery in individual insurance sales in the second half and continued good wealth management sales were the key drivers of earnings in 2007. The annual dividend was increased by 29% in 2007.

We continue to be very impressed with the IAG management. We believe however that further acquisitions will be necessary to maintain EPS growth at the 10% to 12% level over the next 2 years. Management reiterated that it intends to maintain the dividend payout ratio at the 28% level. We expect the annual dividend could be increased to at least \$1.00 per share, a gain of 11% over the next 12 to 15 months.

We have increased our 2008 EPS estimate to \$3.40 from \$3.33, representing an increase of 10% over 2007 which is the lower end of management's guidance of 10% to 13%. Of the \$0.07 EPS increase, \$0.04 was due to the L'Excellence acquisition and a smaller portion was attributed to a modest reduction in the expected tax rate. For 2009, we have introduced our EPS estimate at \$3.70 which represents a further gain of 9%. We have maintained our HOLD as the 12 month expected return is 14.2%.

Valuation

We are impressed with the strong individual insurance sales in the quarter and believe IAG remains in a good position to continue to leverage its Wealth Management group through new product offerings and higher product sales, however, we now believe that IAG will continue to require further acquisitions in order to add to this organic growth. We expect IAG to support a P/E multiple about 8% to 10% below the average of the other major life insurers. Our 12-month target price is being maintained at \$41.00.

Third Party ABCP Write-Down Of 15% Felt To Be Adequate

IAG reported in Q3/07 an exposure to 3rd party (non-bank) Asset Backed Commercial Paper (ABCP) of \$104 million. Management estimated that the liquidity crisis had eroded the fair value of its holdings by about 15%, whereby IAG took a write-down of \$7.3 million after-tax or \$0.09 per share. We had expected a further write-down in Q4/07 however management indicated that the current reserve was adequate. We remain cautious and believe a further write-down of a similar amount is inevitable.

IAG Acquires L'Excellence – Expects \$0.04 Per Share Accretion In 2008

IAG completed the previously announced acquisition of L'Excellence Life Insurance Company (L'Excellence) on January 31, 2008. L'Excellence specializes in individual disability and health insurance as well as brokerage. Its products are largely distributed in Quebec through independent brokers and agents. The cost of this acquisition is estimated at \$67 million and financed in part with common shares of IAG. Management expects the acquisition to give IAG an entry into this market segment and be accretive by \$0.04 per share to IAG in 2008.

Strain On Individual Insurance Dropped Dramatically In Q4/07

The quarter was driven by lower strain of \$22.5 million or 46% of sales down from \$25.2 million last year where strain represented 57% of sales. The lower strain was in part the result of a shift into sales of products that are less strain intensive as well as overall strong individual insurance sales in Q4/07 and a successful product re-pricing. We expect strain in 2008 to be closer to the lower end of management's target range of 50% to 55%.

Other Quarterly Highlights

- Total net operating earnings in Q4/07 were reported at \$63.1 million or \$0.78 per share, up 12% Y/Y.
- Individual Insurance group reported net income of \$28.8 million in Q4/07, a 32% Y/Y gain. The quarter was driven by lower strain and strong individual insurance sales as discussed above. Individual insurance sales ended up 4% Y/Y which is impressive given that after the first nine months of 2007 sales were down 2% Y/Y. Q4/07 sales were \$48.9 million up 20% Y/Y. Recent product changes seem to now be paying off and could see good sales gains into 2008. We do expect however that strain will increase back to the low 50% level next year.
- Net income from wealth management was \$19.4 million in Q4/07 down marginally from \$19.9 million in Q4/06. For 2007, net income was up 1% Y/Y and represented 31% of total IAG net income down from 34% last year. The group reported strong mutual fund sales in 2007 up 46% Y/Y. Seg fund sales were up 3% Y/Y. Net sales of all investment funds were up 58% Y/Y.
- Total funds under management increased to \$15.1 billion for an 8% Y/Y gain but were down 1% sequentially. We expect that net sales may have turned into net redemptions in January in line with that reported by other major mutual funds. As we have noted previously, we expect IAG to remain focused on wealth management and we expect to see this sector continue to grow through acquisitions.
- Group Insurance earnings in Q4/07 were reported at \$10.6 million down from \$11.1 million last year. Experience losses of \$2.7 million were well above the \$0.6 million last year. Group Pension earnings were reported at \$5.8 million up 11% Y/Y. Sales were up 11% Y/Y.
- IAG repurchased 521,000 common shares over the last several months (391,000 at the end of 2007 and 130,400 at the beginning of 2008). The shares repurchased were largely designed to offset those issued in the L'Excellence transaction.

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