

## INDUSTRIAL ALLIANCE INSURANCE (IAG - \$38.07)

### Recommendation

Hold

### Risk

Low

### Target Price

\$40.50

### Price

\$38.07

### 52-Week Range

\$32.14 – 43.75

### % Below High

-13.0%

### % Above Low

18.4%

### Shares O/S

80 million

### Market Cap

\$3.1 billion

### Average Daily Volume

20 day: 149,600

### Year-End

December 31

C\$	EBITDA	Multi.
2007a	\$3.08	12.4x
2008a	\$3.27	11.6x
2009e	\$3.63	10.5x
Book Value	\$21.69	1.8x

	Amount	Yield
Dividend	\$0.90	2.4%

### Analysts

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MBA



Data Source: www.BigCharts.com

### WEAK UNDERLYING Q1/08 EARNINGS

#### CONCLUSION: HOLD - 12 MONTH TARGET LOWERED TO \$40.50

IAG reported adjusted operating earnings for Q1/08 of \$0.76 per share. These earnings however included tax recoveries of about \$0.07 per share which put EPS closer to \$0.69 or about \$0.08 below expectations. Group Insurance earnings (excluding the tax recoveries) declined 15% driven by poor experience gains and higher auto and home claims. Wealth Management earnings declined 7% due to volatile markets and lower net sales. Adjusted operating ROE in the quarter was 14.4% down from 15.2% in the same period last year.

We believe 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 modestly over the next 12 months to at least \$0.96 per share, a gain of 6%.

We have lowered our 2008 EPS estimate to \$3.27 from \$3.40, representing an increase of 6% over 2007 which includes the L'Excellence acquisition and a modest reduction in the expected tax rate. Our estimate is below management's guidance of 10% to 13% earnings growth. For 2009, we have lowered our initial EPS estimate of \$3.70 to \$3.63 which now represents a gain of 11% over our 2008 estimate. We have maintained our HOLD as the 12 month expected return is 8.7%.

### Valuation

We are impressed with management 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 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 at least 10% below the average of the other major life insurers. Our 12-month target price has been lowered to \$40.50 from \$41.00.

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

IAG's exposure to 3rd party (non-bank) Asset Backed Commercial Paper (ABCP) is \$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 in Q3/07. We had expected a further write-down in Q1/08 however management indicated that the current reserve was adequate. Management recently received more detail on the asset quality in the ABCP's held with \$10.7 million in the risk categories Mid-High & High (\$9.1 million being sub-prime assets). We remain cautious and believe a further write-down of a similar amount is still a possibility particularly on a mark to market basis.

### **L'Excellence Update – Management Expects \$0.04 Per Share Accretion In 2008**

IAG completed the 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 was \$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 indicated that the EPS contribution in Q1/08 earnings was about \$0.01.

### **IAG Acquires U.S. Life Insurance Shell Company – No Material Impact**

IAG announced that it has agreed to acquire a shell life insurance company in the U.S. for US\$3.0 million for the purpose of obtaining licences to operate in 49 states. The intent is to build a presence in the U.S. and brand its product IA American Life. This will add to the office that IAG opened in Phoenix, Arizona in 2007.

### **Other Quarterly Highlights**

- Total net adjusted operating earnings in Q1/08 were reported at \$61.7 million or \$0.76 per share, up 6% Y/Y. Excluding a GST recovery of \$2.9 million before-tax (about \$0.02 per share) and a \$4.0 million income tax recovery (\$0.05 per share), EPS was \$0.69 per share. These earnings also include a \$1.6 million (\$0.02 per share) negative adjustment due to the mark to market of debt instruments under the new accounting rules recently adopted.
- Individual Insurance group reported net income of \$30.1 million in Q1/08, a 7% Y/Y gain. Individual insurance sales increased by 6% Y/Y but experienced an increase in strain (cost of writing new business) to 56% of sales which although in line with expectations was nonetheless higher than the previous quarter at 46%. Recent product changes seem to now be paying off and could see good sales gains in 2008. We do expect however that strain will remain near the 55% level this year.
- Net income from wealth management was \$18.7 million in Q1/08 down 7% Y/Y. The group reported a Y/Y 23% drop in sales of both mutual funds and segregated funds. Net sales of all investment funds were down 57% Y/Y. Total AUM increased by 1% Y/Y to \$14.9 billion. Total funds under management decreased to \$14.9 billion from \$15.1 billion at the end of last quarter but were up 1% Y/Y. As 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 Q1/08 were reported at \$8.6 million down 15% Y/Y. Experience losses of \$3.0 million were well above the \$0.2 million last year due to poor long-term disability results. Auto and home insurance claims were also higher as that subsidiary reported a loss of \$2.1 million (pre-tax) due to poor climate conditions this past winter. Group Pension earnings were \$4.8 million up 14% Y/Y. Sales were down 41% Y/Y due to timing issues for new contracts.
- IAG repurchased 197,250 common shares over the last quarter. This amount combined with the 391,000 purchased at the end of 2007 largely offset the shares issued in the L'Excellence transaction.

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