

## SUN LIFE FINANCIAL (SLF-TSX - \$47.30)

**Recommendation**

BUY

**Risk**

Low

**Target Price**

\$58.00

**Price**

\$47.30

**52-Week Range**

\$45.44 – 56.50

**% Below High**

-16.2%

**% Above Low**

4.0%

**Shares O/S**

564 million

**Market Cap**

\$24 billion

**Average Daily Volume**

1,398,168

**Year-End**

December 31

C\$	EPS	Multi.
2007a	\$3.98	11.9x
2008e	\$4.35	10.9x
2009e	\$4.70	10.1x
Book Value	\$27.70	1.7x

	Amount	Yield
Dividend	\$1.44	3.0%

**Analysts**

Robin Cornwell



Data Source: www.BigCharts.com

### Q4/07 LOWER THAN EXPECTED NEGATIVES OF THE STRONGER C\$ HIGHER THAN EXPECTED DIVIDEND INCREASED BY 6%

### CONCLUSION: BUY - 12 MONTH TARGET LOWERED TO \$58.00

Operating EPS reported at \$0.98, up 4% Y/Y and below our forecast by \$0.05. The quarter was somewhat noisy with currency being a negative of \$0.07 and much larger than we expected. On a constant currency basis EPS would have increased by 12% Y/Y. Offsetting the currency was a strong performance from U.S. Individual Life earnings which benefited from a new funding program implemented. ROE decreased to 14.3% in the quarter from 14.8% last quarter but was up from 14.0% in Q4/06. The annual dividend per share was increased by 6% to \$1.44 from \$1.36.

For 2007 SLF reported operating EPS (fd) of \$3.98 up from an adjusted \$3.58 in 2006, a gain of 11%. Excluding the FX impact, Y/Y earnings in constant currency were better by over 13%. ROE averaged 14.3% up from 13.8% in 2006. The dividend per share increased by 20% in fiscal 2007.

We are scaling back our 2008 estimate to \$4.35 from \$4.42 due to the strong C\$ and lower projected growth in AUM and a lower return from investments. The 2008 estimate factors in the expected \$0.05 accretion in 2008 from the Genworth U.S. Group Benefits business (see below) and good earnings gains in Asia but slower earnings growth at MFS due to slower AUM growth expected. If the C\$ strengthens beyond the \$1.01 level versus the US\$, then we may have to revisit and lower our 2008 estimate. We have introduced our 2009 EPS estimate at \$4.70

which is slightly below management's objective of a 10% average EPS growth. The dividend payout ratio approximates 33% of our 2008 EPS estimate. Investors should expect a dividend increase of 10% to 12% over the next 12 months to the \$1.60 level which be a lower rate of increase than the 20% experienced last year.

Our 12 month share price target valuation has been lowered to \$58.00 from \$61.00 which attributes a P/E on the insurance earnings closer to the average of SLF's peers and but puts a lower valuation on MFS and CI Financial as AUM levels will be difficult to maintain with the current uncertain market volatility. We have maintained our Buy recommendation. The total expected return over the next 12 months is 25.7%.

### Valuation

We value SLF on a component basis and have split our valuation between the life insurance business and the asset management business. We have placed a 12-month target valuation on the life insurance business of \$42.90 and a valuation on the wealth management group of \$15.10 for a total valuation of \$58.00.

In summary, our valuation for SLF is based on the two principal components:

- (1) **Sun Life Assurance**, the core insurance business, which we believe will support a P/E of 13.1x 2008 net earnings or \$42.90, which is more in line with the average of SLF's peers and,
- (2) **Sun Life Financial**, the asset management business valued at \$15.10 per SLF share down from \$16.50, which includes:
  - MFS, the U.S. asset manager (approx. 96% owned), which we believe should support a P/E of 18x our 2008 forecast earnings of contribution to SLF of \$0.53 per share or \$9.50 per SLF share.
  - McLean Budden, institutional investment management company (56% owned). We estimate that McLean Budden should support a multiple of 22x estimated earnings of \$39 million which would represent an equity value of approximately \$0.85 per SLF share.
  - C.I. Financial mutual fund management company (36.5% owned). We value C.I. Financial based on our 12 month target price which was recently lowered to \$26.50 from \$29.50 and which now translates into \$4.75 per SLF share.

### Negative Currency Impact To Remain A Drag On Next Several Quarters

Constant currency EPS was \$1.05 in Q4/07 versus a reported operating EPS of \$0.98 which would imply an increase Y/Y of 12% versus the 4% reported. The negative impact in Q4/07 alone was \$41 million. For fiscal 2007 constant currency EPS was \$4.06 versus the \$3.98 reported for a gain of 13% over \$3.58 in 2006.

Based on the current C\$:US\$ exchange rate we would expect the negative impact on EPS to continue in fiscal 2008 representing 3% to 4% of our 2008 EPS forecast. As a consequence our 2008 EPS forecast of a 9% Y/Y increase would be 12% on a constant currency basis.

### SLF U.S. Reports Much Stronger Earnings Helped By Equity Markets

The U.S. operations of SLF reported a strong Q4/07 reporting net income of \$157 million up 62% Y/Y. On a constant currency basis net income advanced 92% Y/Y. The improvement was the result of the addition of the Genworth Financial's U.S. Employee Benefits Group (EBG) which experienced an increase in business in-force to US\$2.1 billion from US\$1.2 billion in Q4/06. The quarter also benefited about \$60 million from the establishment of an unsecured long-term financing arrangement to address U.S. statutory requirements for certain universal life policies otherwise referred to as AXXX.

**MFS – Continued Strong Earnings – 2008 Estimates Lowered Marginally**

MFS reported solid Q4/07 earnings of \$73 million up 7% Q/Q and up 3% Y/Y (20% increase Y/Y in US\$). Excluding unusual items core earnings were closer to \$70 million. AUM increased by 7% Y/Y to US\$200 billion but was down from US\$204 million last quarter due to weak and volatile equity markets. Pre-tax margins increased to 40% from 36% last quarter and up significantly from 34% in Q4/06. Adjusted for the unusual items margins would have been closer to the 36% experienced last quarter. Margins are expected to stabilize at closer to the 36% level over the next 12 months as MFS recently made investments in its global distribution and added to its investment teams.

Net redemptions on retail mutual funds in Q4/07 were somewhat disappointing as they increased to US\$1.9 billion up from US\$1.4 billion last quarter and about the same as the \$1.4 billion quarterly net redemption run rate in 2006. Retail redemptions were US\$6.0 billion due to the volatility in the U.S. market. Gross retail sales continued good however at US\$4.1 billion flat Y/Y. Net Managed Funds (largely Institutional) experienced a redemption of US\$1.3 billion resulting from 2 large institutional withdrawals. Total net sales for MFS were a negative US\$3.2 billion in the quarter. Market movement accounted for US\$1.5 billion of the AUM decrease in the quarter.

Total estimated MFS contribution to SLF in 2007 was \$0.50 per SLF share. We have lowered our estimated 2008 MFS contribution to SLF to \$0.53 per SLF share from \$0.58 per SLF share due to a lower AUM expected for Q1/08 and the high volatility in equity markets. We forecast a further 8% increase in 2009 to \$0.58 per SLF share.

**Other Quarterly Highlights**

- Net income in Q4/07 was reported at \$560 million up 4% Y/Y. As noted earnings on a constant currency basis would have been closer to \$601 million for a gain of 10% Y/Y. For 2007, earnings increased to \$2.3 billion a gain Y/Y of 10% but in constant currency closer to 12%.
- Net income from the Canadian operations in Q4/07 was \$263 million up 2% from \$257 million last year. The quarter showed modest sales growth in Individual Insurance up 4% Y/Y. Individual Wealth reported sales up 8% Y/Y helped by new products. Individual segregated fund sales increased 37% Y/Y benefiting from the new SunWise Elite Plus product. Group pension net income increased to \$76 million from \$60 million in Q4/06 as last year.
- SLF Asia reported stronger earnings of \$38 million up 15% from \$30 million last year. Sales in Asia continued strong increasing to \$203 million up from \$171 million last quarter and \$95 million on a Y/Y basis.
- SLF repurchased about 2.5 million common shares in Q4/07 for \$129 million bringing the total for 2007 to \$502 million. Our 2008 and 2009 EPS estimates are based on a share repurchase program of 10.5 million shares.
- Management indicated that a 10% decline in equity markets would lower earnings by about 6%.

**Sub-Prime Mortgage Lending Exposure Remains Relatively Small**

Management detailed its exposure in asset backed bonds with the total exposure at C\$6.6 billion of which 99.6% were investment grade. The bulk of its investments are in Commercial Mortgage Backed Securities (CMBS) and Residential Mortgage Backed Securities (RMBS) which are virtually 99.9% investment grade and fixed rate. It was also indicated that the exposure to the sub-prime mortgage lending is relatively small at \$337 million.

**Recent U.S. Group Benefits Acquisition**

SLF completed its acquisition of Genworth Financial's U.S. Employee Benefits Group (EBG) on May 31, 2007 for US\$650 million. EBG's operations offer primarily group life, disability, stop-loss and dental insurance. The acquisition of EBG should prove strategically positive with low integration risks as it will add to SLF's existing U.S. group business and position it as the #5 provider of Group Life & Disability insurance in the U.S. plus make it the #2 provider of medical stop-loss insurance. This seems to be a relatively good purchase overall as it will add much needed scale and distribution for SLF in the U.S. market. The purchase was paid for in cash. Management continues to expect the acquisition to be accretive in 2008 by \$0.05 per share and add 10bp to ROE.

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