William Blair & Company®

Equity Research

FINANCIAL
Insurance

February 13, 2008
Research Note

Ticker:	NFP
Market:	NYSE
Price:	$28.21
52-week:	($26-$57)

Stock Rating:
Outperform

Company Profile:
Core Growth

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National Financial Partners Corp.

Fourth Quarter—Credibility Badly Marred, But We Remain Believers in the Business Model; Stock Very Inexpensive

FINANCIAL SUMMARY

Fiscal Year Ends:	December	Dividend/Yield:	$0.84/3.0%
Long-term EPS Growth Rate:	18%	Market Value (mil.):	$1,096

ESTIMATES*

FYE	Q1	Q2	Q3	Q4	Annual	P/E
2007A	$0.53	$0.76	$0.75	$0.83	$2.86	9.9x
2008E	NA	NA	NA	NA	$3.15	9.0x
2009E	NA	NA	NA	NA	$3.50	8.1x
Cal2008					$3.15	9.0x
Cal2009					$3.50	8.1x

**** Estimates reflect the adoption of FAS 123R.***

Highlights

> Cash EPS increased 5%, to $0.83, and were in line with preannounced results. Our original estimate was $0.97 per share, with the shortfall being driven by slower organic revenue growth given a slower-than-expected recovery in the overall life insurance market and negative operating leverage. The slower growth also created in part a negative tax impact, given an increase in the percentage of nondeductible expenses relative to pretax operating income.

> Organic revenue growth (e.g., same-store sales) was 7.6%. While organic growth was below our estimate, it showed a marked increase from first-half growth.

> Management provided some enhanced disclosure that we believe supports the integrity of the business model, although given the disappointing financial results over the past several quarters, credibility in management and the business model has clearly been marred. Given that affiliated firms do not earn incentives until growth exceeds 10% and the affiliated firms own an operating asset that can be sold at some future date, we believe that proper incentives are in place to drive reasonable returns for shareholders.

> The quality of the pipeline remains high and the company has already hit 50% of its acquisition target for the year. Given the drop in National Financial Partners' stock price and management's increased willingness to repurchase stock, a more aggressive share repurchase position could affect acquisition activity a bit for the year.

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> Commensurate with its disappointing earnings preannouncement, management pulled its annual earnings guidance, stressing that its long-term growth goal was to produce high-single-digit organic revenue growth and double-digit percentage cash EPS growth. We have lowered our 2008 cash EPS estimate to $3.15 from $3.30 and our 2009 cash EPS estimate to $3.50 from $3.70, representing 10% growth and 11% growth, respectively. If the company executes well, these estimates should prove conservative, although we have taken a less aggressive posture given recent results.

> Our rating remains Outperform, although we agree recent financial results have been disappointing. We continue to believe in the integrity of National Financial Partners' acquisition model and the growth characteristics of its underlying markets, and we believe the stock is extremely inexpensive at less than 9 times our 2008 cash EPS estimate.

Discussion

Underlying Growth Improving, But Not Fast Enough to Qualm Concerns About Model

Cash EPS increased 5% to $0.83, in line with preannounced results. The slower growth also created in part a negative tax impact, given an increase in the percentage of nondeductible expenses relative to pretax operating income. Our original estimate was $0.97 per share, with the shortfall being driven by slower organic revenue growth given a slower-than-expected recovery in the overall life insurance market and negative operating leverage. Life insurance represents about 60% of National Financial Partners' acquired revenue and we estimate that its commission and fee revenue is about 55% recurring. Therefore, organic growth and margins can be volatile in any given period due to changes in pricing, changes in underwriting practices, anticipated regulatory changes, etc. Cash EPS for the year increased only 10% after a historical low growth rate of 4% in 2006. Cash EPS has increased at a compound annual rate of 13.5% during National Financial Partners' four years as a public company. We expected growth to recover more substantially this year given a more rapid recovery in the life insurance market, but there have been no structural changes in the industry environment that affect our long-term view. In fact, a Democratic presidential winner in 2008 could actually help growth given that income taxes would go up and estate taxes could go up dramatically.

Organic revenue growth (e.g., same-store sales) was 7.6%. While organic growth was below our estimate, it showed a marked increase from first-half growth. Organic growth by quarter this year was -12.3%, -2.7%, 6.8%, and 7.6%, respectively, and 0.3% for the year compared with 5.4% in 2006 and 20% in 2005, as growth has slowed in response to slower premium financed life in late 2005 and early 2006. In 2008, we forecast organic revenue growth of 8% to 10%. The company's average organic growth in its four full years as a public company has been about 10%. Given the significant influence of premium financed life sales over the past few years, and the fact that premium financed life sales and other certain sales often include payments to third-party providers, management also provides "net same store" revenue growth. And we agree with management this is a better measure to assess the company's growth given this measure eliminates shared commissions and payments to third parties. Net organic growth was 2.6% in 2007, 1.4% in 2006, and 17.0% in 2005 and has averaged 9.2% during National Financial Partners' first four full years as a public company.

Total revenue increased 15.0%, to $355 million, for the fourth quarter (11% for the year) given 7.6% organic growth, a higher contribution from acquisitions, and continued growth at NFP Insurance Services and NFP Securities, the latter being the company's broker-dealer that all affiliates are required to join. We estimate that revenue from existing firms contributed more than 85% of revenue for the quarter, which is lower than management's disclosure given the way that management reports revenue running through its broker-dealer. In 2007, a total of 58% of National Financial Partners' revenue was life insurance, 32% was benefits, and 10% was financial planning and investment advisory (acquired firms only). Within the life insurance business specifically, 53% of the business was the more stable life brokerage (small retail agents as clients) business compared with 47% for retail life. Management remains committed to increasing recurring revenue by moving more toward the benefits business, which is where the majority of acquisition activity has been targeted, as well as the advisory business and life brokerage within the life business. Assets under management in the corporate RIA business were $8.5 billion, up 23% over the last 12 months.

Gross Margin Actually Up—Very Difficult to Predict

The gross margin represents total commissions and fees less the cost of commissions and fees (payouts to nonprincipal producers and other third parties), operating expenses at the individual firm level (that the individual firms manage), and the management fee (payments made to principal producers including incentive compensation). The incentive compensation system is preset at the time of the transaction and cannot be changed. The incentive compensation for the first three-year incentive period following an acquisition is recorded as an earn out and allocated to the purchase price, while the second three-year incentive compensation plan, and all subsequent plans, flow through the management fee. The gross margin less corporate expenses and interest expense/income equates to pretax cash earnings.

The gross margin was 19.1% compared with 18.9% in fourth quarter 2006 as the management fee percentage dropped due to lower growth and mix shift toward firms in which National Financial Partners owns a greater economic interest. However, this benefit was almost entirely offset by some negative operating leverage in regard to operating expenses and higher commissions and fees. NFP management has no control over operating expense at the firm level, but the firms are presumably driven to manage operating expenses carefully given that incentive payments are tied to earnings growth. Commissions and fees increased to 32.3% of total revenue from 31.4% given faster growth in the company's independent broker-dealer, which has higher payouts. The management fee percentage (management fee divided by gross income less the management fee) was 50.0% compared with 53.6% in fourth quarter 2006.

Some More Disclosure to Support Integrity of Model

Management provided some enhanced disclosure that we believe supports the integrity of the business model, although given disappointing financial results over the past several quarters credibility in management and the business model has clearly been marred. The new disclosure included certain performance measures by acquisition cohort (year in which firms were acquired), illustrating that certain firms continue to earn incentive payments beyond the first incentive period and certain firms that do not earn incentive payments in the initial period have earned an incentive payment in future periods. About 50% of the firms acquired through the end of 2007 earned the initial earnout (first three years following an acquisition) and 70% of the firms acquired through the end of 2007 earned the initial earnout or achieved an award during the first three-year incentive period following the earnout period. We note that 15% of the firms achieved an incentive payment in the second three-year incentive period after failing to receive an initial earnout. Finally, 55% of the firms that were acquired on January 1, 1999, and therefore have completed a third three-year incentive period, earned an incentive for the latest incentive period. We believe the disclosure supports the view that there is durability within the incentive structures. Firms that do not believe they can grow should not sell their businesses to National Financial Partners, given that affiliated firms do not earn incentives until growth exceeds 10% and the affiliated firms own an operating asset that can be sold at some future date.

Already Halfway to Acquisition Goal, More Aggressive Share Repurchase Could Displace Some Activity

National Financial Partners announced it acquired eight firms as of January 1, 2008, representing $10.9 million of base earnings and a solid, although not spectacular, start to the year. Management's stated goal is to purchase $20 million of base earnings in 2008—our estimate remains at least $20 million, although our first-quarter estimate was $9.0 million of base earnings. Management continues to remain focused on larger deals, subacquisitions to add to already successful firms, and benefits-oriented firms in order to drive recurring revenue higher. Of the base earnings acquired, $3.9 million related to seven transactions, including four group benefits firms (three of which are subacquisitions), a specialty insurance brokerage focused on bank-owned life insurance products, a property and casualty subacquisition, and an estate planning firm. The remaining $7.0 million of the base earnings acquired related to the acquisition of a group benefits intermediary and its subsequent merger with an existing NFP firm, also a group benefits intermediary. Given the drop in National Financial Partners' stock price (it typically has been using about 30% stock in recent deals) and management's increased willingness to repurchase stock, a more aggressive share repurchase position could affect acquisition activity a bit for the year. Although National Financial Partners ended 2007 with 184 owned firms, since its founding in 1999, the company has completed 249 transactions, including 35 subacquisitions and 7 subsequent internal consolidations, and has disposed of 21 firms.

Lowering Estimates Given Difficulty in Achieving Recent Expectations

Commensurate with its disappointing earnings preannouncement, management pulled its annual earnings guidance, stressing that its long-term goal was to produce high-single-digit organic revenue growth and double-digit percentage cash EPS growth. We have lowered our 2008 cash EPS estimate to $3.15 from $3.30 and our 2009 cash EPS estimate to $3.50 from $3.70, representing 10% growth and 11% growth, respectively. If the company executes well, these estimates should prove conservative, although we have taken a less aggressive posture given sluggish earnings growth the past several quarters. There is the possibility of an accounting change for the treatment of convertible debt instruments that may be settled in cash that could have a $10 million to $12 million impact on 2008 estimates, but this is a noncash expense.

Reiterate Outperform Rating—Stock Way Too Inexpensive

Recent results have been unequivocally disappointing. That said, management remains committed to its long-term strategy, we believe in the growth of National Financial Partners' underlying markets, and we are convinced the company delivers significant value to its affiliated firms. Given its focus on the distribution of high-end life insurance and corporate and executive benefits, as well as financial planning and investment advisory, National Financial Partners' business is neither highly cyclical nor capital markets sensitive, and holds no credit risk—therefore, it is more defensive relative to the average financial services growth stock, in our opinion. However, it is difficult to predict on a quarterly basis, given the lack of significant recurring revenue, and because National Financial Partners does not manage expenses at the affiliate level earnings can move around a lot on revenue volatility. While management needs to rebuild credibility and that could continue to put pressure on the stock in the near term, we view valuation as very inexpensive at less than 9 times estimated enterprise value to 2008 EBITDA (includes share count, cash, and debt needs to generate 2008 EBITDA estimate). We believe National Financial Partners' cash EPS growth will be driven by high-single-digit organic growth, the completion of further acquisitions, eventual benefits from some operating leverage, and more aggressive capital management.

William Blair & Company, L.L.C. and its affiliates beneficially own or control (either directly or through its managed accounts) 1% or more of the equity securities of National Financial Partners Corp. as of the end of the month ending not more than 40 days from the date herein.

Additional information is available upon request.

Current Rating Distribution (as of 2/1/2008)

Coverage Universe	**Percent**	**Inv. Banking Relationships***	**Percent**
Outperform (Buy)	59	Outperform (Buy)	13
Market Perform (Hold)	40	Market Perform (Hold)	6
Underperform (Sell)	1	Underperform (Sell)	1

*Percentage of companies in each rating category that are investment banking clients, defined as companies for which William Blair has received compensation for investment banking services within the past 12 months.

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Company Profile: The William Blair research philosophy is focused on quality growth companies. Growth companies by their nature tend to be more volatile than the overall stock market. Company profile is a fundamental assessment, over a longer-term horizon, of the business risk of the company relative to the broader William Blair universe. Factors assessed include: 1) durability and strength of franchise (management strength and track record, market leadership, distinctive capabilities); 2) financial profile (earnings growth rate/consistency, cash flow generation, return on investment, balance sheet, accounting); 3) other factors such as sector or industry conditions, economic environment, confidence in long-term growth prospects, etc. Established Growth (E) – Fundamental risk is lower relative to the broader William Blair universe; Core Growth (C) – Fundamental risk is approximately in line with the broader William Blair universe; Aggressive Growth (A) – Fundamental risk is higher relative to the broader William Blair universe.

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