12 July 2013 │ 17 pages

Other Diversified Financial Services (GICS) │ Diversified and Specialty Finance (Citi)
Australia/NZ │ Australia

Challenger Ltd (CGF.AX)

Spread stability important with book growth likely slowing

- Estimate Change

- **Positive mark to market, keep Neutral** — We lift our FY13E core EPS by 7.4% to 75.3cps due to mark to market changes. Given fixed interest spreads have moved in different ways in 2H13, depending on risk grading, the market adjustment probably has more room for error than usual but we calculate a positive adjustment of A$27m after tax for 2H13E overall. The stock continues to trade on a low p/e multiple and looks vulnerable to positive catalysts but we struggle to identify a major one just yet.

- **But no change to normalised EPS** — Our FY13E normalised EPS remains 56.4cps.

- **Forecasting further Life spread contraction …** — We forecast a slowing in the rate of decline in spread in 2H13 to 9bps from the close to 30bps 1H13 vs. 2H12. However, with lower cash rates likely pressurising earnings on the estimated ~A$1.5bn of shareholders' funds, the NIM bond continuing to run-off and the run-off of ~A$300m of higher spread products scheduled for March 2014, we continue to forecast further contraction in FY14E.

- **… but could Life spreads stabilise sooner than we think?** — Potentially offsetting some of our concerns, Challenger recently suggested there were plenty of investment opportunities for it to earn a reasonable return, e.g. its recent Federation Centres deal. We therefore see some risk Challenger may be able to provide some evidence that it can stabilise spreads earlier than our analysis suggests.

- **Risk of slowing book growth in FY14E** — Challenger is likely to continue its move away from providing sales growth guidance, instead focusing more on retail book growth in future. With this targeted for 7.5% in FY13 and not too many obvious factors to materially increase it in FY14E, we would be surprised if the underlying growth rate accelerates much next year. This may mean that with a little ~A$300m of run-off expected from the three-year term expiring in March 2014 on the annuity offered to investors previously in the High Yield Fund (reducing book growth by ~4% assuming no reinvestment), actual FY14E book growth is very subdued, possibly <5%.

Neutral	**2**
Price (12 Jul 13)	A$4.27
Target price	A$4.10
Expected share price return	-4.0%
Expected dividend yield	4.6%
Expected total return	**0.6%**
Market Cap	A$2,267M
	US$2,083M

Price Performance
(RIC: CGF.AX, BB: CGF AU)

CGF.AU revisions (Y/E Jun)	2011A	2012A	2013E	2014E	2015E
Reported Profit (A$m)	261.4	148.5	399.7	311.0	288.1
% revision	0.0%	0.0%	7.3%	0.0%	0.0%
Core Net Profit (A$m)	219.3	148.5	399.7	311.0	288.1
% revision	0.0%	0.0%	7.3%	0.0%	0.0%
Core EPS (A¢)	42.5	27.8	75.3	60.0	55.2
% revision	0.0%	0.0%	7.4%	0.2%	0.2%
EPS Growth (%)	10.6	-34.5	170.5	-20.3	-7.9
PE Ratio (x)	10.0	15.3	5.7	7.1	7.7
DPS (A¢)	16.5	18.0	19.5	20.0	20.0
Dividend Yield (%)	3.9	4.2	4.6	4.7	4.7
Franking Rate (%)	0.0	0.0	0.0	0.0	20.0

Source: Company Reports and dataCentral, Citi Research.

Nigel Pittaway
+61-2-8225-4860
nigel.pittaway@citi.com

Mark Tomlins
+61-2-8225-4849
mark.tomlins@citi.com

Joyce Tong
joyce.tong@citi.com

See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

CGF.AX: Fiscal year end 30-Jun — **Price:$4.27; TP:$4.10; # Shares: 531m; Market Cap: A$2267m; Recomm: Neutral**

Profit & Loss (A$m)	**2011**	**2012**	**2013E**	**2014E**	**2015E**
Sales revenue	814	890	924	969	1,024
Cost of sales	-445	-502	-515	-545	-590
Gross profit	369	389	409	424	434
EBITDA (Adj)	**391**	**400**	**423**	**438**	**448**
Depreciation	-6	-7	-10	-10	-10
Amortisation	-16	-4	-4	-4	-4
EBIT (Adj)	**369**	**389**	**409**	**424**	**434**
Net interest	-44	-198	134	-5	-5
Earnings before tax	**325**	**190**	**543**	**419**	**429**
Tax Recurring	-51	9	-92	-55	-86
Non-op/Except/Extraord	-13	-50	-52	-53	-55
Minority interests	0	0	0	0	0
Associates	0	0	0	0	0
Reported net profit	**261**	**149**	**400**	**311**	**288**
Core NPAT	219	149	400	311	288

Half year data (A$m)	**1H12**	**2H12**	**1H13**	**2H13E**	**1H14E**
Sales revenue	441	449	458	466	478
EBIT (Adj)	186	203	203	206	208
Core NPAT	20	129	222	178	152
Core EPS (¢)	3.8	23.8	41.5	33.8	29.2

Balance Sheet (A$m)	**2011**	**2012**	**2013E**	**2014E**	**2015E**
Cash & cash equiv.	404	426	808	965	1,077
Accounts receivables	0	0	0	0	0
Inventory	na	na	na	na	na
Net fixed & other tangibles	375	531	430	380	330
Goodwill & intangibles	519	519	509	489	470
Financial & other assets	8,143	9,581	10,132	10,969	11,852
Total assets	**9,440**	**11,058**	**11,879**	**12,804**	**13,729**
Accounts payable	282	239	279	297	313
Short-term debt	0	0	0	0	0
Long-term debt	652	672	678	681	684
Provisions & other liab	7,018	8,454	8,970	9,668	10,389
Total liabilities	**7,952**	**9,366**	**9,927**	**10,646**	**11,386**
Shareholders' equity	1,488	1,692	1,952	2,158	2,342
Minority interests	0	0	0	0	0
Total equity	**1,488**	**1,692**	**1,952**	**2,158**	**2,342**
Net debt	**249**	**246**	**-130**	**-284**	**-392**

Cashflow (A$m)	**2011**	**2012**	**2013E**	**2014E**	**2015E**
EBITDA	391	400	423	438	448
Working capital	0	0	0	0	0
Net interest paid	502	677	303	0	0
Tax paid	2	-2	-2	0	0
Other	608	299	143	385	375
Operating cashflow	**1,504**	**1,374**	**867**	**823**	**823**
Capex	-37	-46	-25	-20	-20
Net acq/disposals	-1,124	-1,158	-318	0	0
Other	1,630	1,595	745	0	0
Investing cashflow	**469**	**391**	**402**	**-20**	**-20**
Dividends paid	-75	-86	-107	-103	-104
Financing cashflow	**-1,646**	**-1,621**	**-905**	**-103**	**-104**
Net change in cash	**326**	**144**	**364**	**700**	**698**
Free cashflow to s/holders	**1,467**	**1,328**	**842**	**803**	**803**

Per share data	**2011**	**2012**	**2013E**	**2014E**	**2015E**
Reported EPS (¢)	50.7	27.8	75.3	60.0	55.2
Core EPS (¢)	42.5	27.8	75.3	60.0	55.2
DPS (¢)	16.5	18.0	19.5	20.0	20.0
CFPS (¢)	291.5	257.6	163.4	158.7	159.5
BVPS (¢)	299.6	310.7	367.7	413.1	450.6
Wtd avg ord shares (m)	479	517	527	514	508
Wtd avg diluted shares (m)	516	533	531	518	513

Valuation ratios	**2011**	**2012**	**2013E**	**2014E**	**2015E**
PE (x)	10.0	15.3	5.7	7.1	7.7
EV/EBIT (x)	-13.7	-16.2	-18.3	-19.9	-21.7
EV/EBITDA (x)	-12.9	-15.8	-17.7	-19.3	-21.1
FCF yield (%)	66.6	58.3	37.2	36.3	36.4
Dividend yield (%)	3.9	4.2	4.6	4.7	4.7
Payout ratio (%)	39	65	26	33	36

Growth rates	**2011**	**2012**	**2013E**	**2014E**	**2015E**
Sales revenue (%)	-6.5	9.4	3.8	4.8	5.7
EBIT (Adj) (%)	2.3	5.4	5.2	3.6	2.5
Core NPAT (%)	4.7	-32.3	nm	-22.2	-7.4
Core EPS (%)	10.6	-34.5	nm	-20.3	-7.9

Operating performance	**2011**	**2012**	**2013E**	**2014E**	**2015E**
Operating ROA (%)	2.5	1.4	3.5	2.5	2.2
Operating ROE (%)	15.5	9.3	21.9	15.1	12.8
Operating ROIC (%)	57.9	55.2	42.5	58.8	64.3
Net debt to equity (%)	16.71	14.52	-6.67	-13.18	-16.75
Debt to total capital (%)	30.5	28.4	25.8	24.0	22.6
Interest coverage (x)	9.0	2.0	na	87.5	89.6
Tangible BVPS (A$)	2.0	2.2	2.7	3.2	3.6
P/Tangible BVPS (x)	2.19	1.98	1.57	1.34	1.19
Market Cap to Funds Under	9.6	7.3	5.8	5.4	5.0

Segmental revenue (A$m)	**2011**	**2012**	**2013E**	**2014E**	**2015E**
Mortgage Management (sold)	0	0	0	0	0
Funds Management	62	66	72	76	80
Challenger Life Company	752	824	852	893	945
Revenue - total segments	813.6	890.4	924.1	968.7	1,024.4

Segmental EBIT (A$m)	**2011**	**2012**	**2013E**	**2014E**	**2015E**
Mortgage Management (sold)	0	0	0	0	0
Funds Management	20	21	28	32	35
Financial Planning (sold)	0	0	0	0	0
Challenger Life Company	349	368	381	392	399
Non-core	0	0	0	0	0
Corporate Charges	-55	-50	-52	-53	-55
Goodwill writedown	0	0	0	0	0
EBIT - total segments	314	338	357	371	379

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The simple story

On track to achieve FY13E guidance

Figure 1. Challenger's FY13E guidance on retail sales and book growth

Metric	Guidance at FY12	Guidance at 1H13	Guidance at 3Q13	Guidance at investor briefing in June 2013
Net retail liabilities target growth	A$675m (~10%)	Lowered to A$500m (~8%)	A$500m (~8%) reiterated	~7.5%
Retail sales target growth	15% (sales of A$2.25bn)	Sales of A$2.1bn (growth guidance halved to 7.5%)	No additional comment from CGF	No additional comment on total retail sales target growth; guiding to ~A$240 of Lifetime sales for FY13E
Life cash operating earnings	A$440m to A$450m	A$440m to A$450m (unchanged)	No additional comment from CGF	At upper end of A$440m to A$450m

Source: Company Reports

At its investor briefing in June, Challenger reiterated its FY13E target for Life CoE of between A$440m and A$450m, although indicated this would be at the upper end of guidance. We forecast Challenger slightly beating guidance, estimating A$227m of Life normalised CoE in 2H13E and A$452m in FY13E.

Challenger also highlighted retail book growth guidance of 7.5% for FY13E, equivalent to or perhaps a minor downgrade from its prior guidance of 8%.

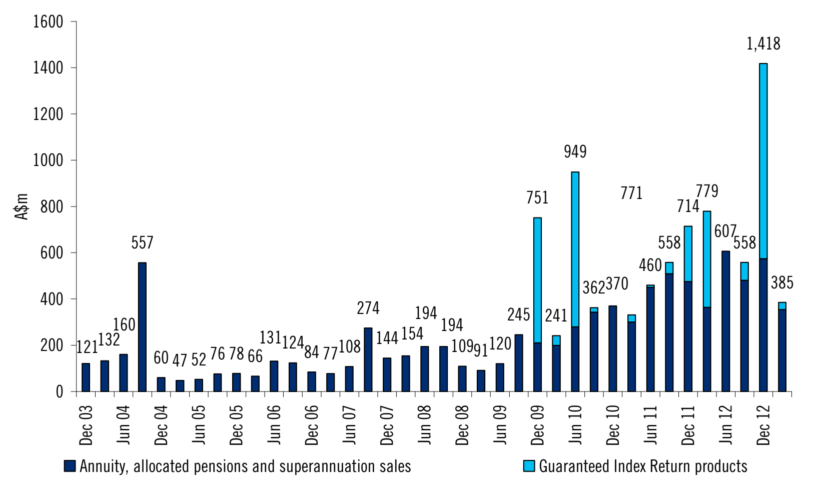
We forecast retail annuity sales of A$675m for 4Q13E and A$2.084bn for FY13E, consistent with sales guidance of A$2.1bn provided at the 1H13 results, although we do see some risk in it achieving this. Despite the run-off of its retail book being difficult to forecast, we presume achievement of its targeted level of sales would enable Challenger to meet its revised net retail liabilities target growth.

Small positive in investment experience

We estimate a small positive investment experience in 2H13, with 1H13 and 1H10 the only other periods showing a positive adjustment over the past five years. We forecast positive investment experience of A$39m pre-tax (A$27m after tax) for the second half, although note that the credit spread movements on its fixed income portfolio are particularly hard to forecast this period, with some indicators showing spreads blowing out and other showing spreads contracting.

Focus on lifetime annuities aiding retail sales

Figure 2. Life product sales



Source: Company Reports

Given the lower interest rate environment must be making sales of fixed term annuities tougher, Challenger has supplemented these with the sale of Liquid Lifetime Annuities, although these are also potentially harder to sell as interest rates fall. Care Annuities sales are small so far but have also contributed and have the advantage of their sales being largely insensitive to interest rate moves.

There was a large drop in Challenger's fixed term annuity sales in the March quarter – down 17% vs. pcp – but we see Liquid Lifetime Annuities and Care Annuities as offering some offsetting growth potential in the near term. The sales of these annuities are, however, relatively small so far and while Challenger is guiding for 400% growth in these sales FY13 vs. FY12 to a level of A$240m, this is still likely to represent only a little over 10% of its total sales.

Nonetheless, we expect Challenger to continue to grow the proportion of its retail sales from lifetime annuities, which should in time, lower run off and make it easier for Challenger to grow its retail liabilities in the medium to longer term. It should also enable investment in longer-dated assets, which earn increased illiquidity and risk premiums.

However, none of this suggests a material near-term acceleration in the rate of book growth over and above the ~7.5% targeted for FY13E. Consequently, with the roll off of the ~A$300m in the annuity that replaced the high yield fund scheduled for March 2014 (potentially stripping ~4% off book growth) and with low likelihood much of this is reinvested, headline book growth could be below 5% in FY14E.

Figure 3. Challenger's recent and implied 4Q13 projected retail annuities sales by category

	2H12 A$m	1H13 A$m	3Q13 A$m	Implied 4Q13E A$m
Care	0	29	29	
Liquid lifetime	30	72	35	
Total Lifetime	**30**	**101**	**64**	**76**
Fixed term	941	954	290	615
Total retail	**971**	**1,055**	**354**	**691**

Source: Company Reports

Deferred Lifetime Annuities growth potential for the long term

In time, we see potential for deferred lifetime annuity (DLAs) sales to boost Challenger's proportion of sales from longer term annuities. However, we believe DLAs are likely a longer-term source of sales growth for Challenger, at the earliest impacting FY15E revenues and, in our view, it will likely be at least FY16E before they become even modestly significant. The Federal Government's proposed extension of concessional tax treatment to DLAs could see these annuities become a lucrative area. However, it is still likely a while before legislation is passed, and in our view, even if all goes according to plan for the Government, it will be 1 July 2014 before the new rules for DLAs come through. A Coalition election victory could see this further delayed, not that they are opposed to DLAs per se, but because they may have other things of higher priority on their agenda. Furthermore, appeal to Australian consumers remains uncertain, suggesting to us it will be at least FY16E and possibly beyond before we see material revenues from DLAs.

Downwards pressure on Life spreads seems likely to continue

Challenger's Life cash operating earnings (COE) spread fell 40bps to 4.53% in 1H13, and we expect it to fall further in 2H13E. We forecast a spread of 4.44% for the half, partly due to the RBA's cuts to the cash rate in December 2012 and May

2013, as well as lower yield enhancement from the NIM bond as it runs off. This results in a forecast of 4.48% for FY13E. Looking forward, in addition to the impact of ongoing run-off of the NIM bond, if market expectations of further reductions in cash rates in 1H14 are correct, we see the potential for further pressure on the Life COE spread.

Figure 4. Estimated margin enhancement for Challenger Life from NIM bond (annualised)

	1H13A	NIM bond deducted	1H13A adjusted
Investment yield	8.5%	30.8%	7.7%
Costs of funding (i.e. interest expense)	-4.5%	0.0%	-4.7%
Commissions & fees	-0.3%	0.0%	-0.3%
Net investment income margin	**3.7%**	**30.8%**	**2.7%**
Change			1.0%

Source: Company Reports and Citi Research Estimates

At its recent investor briefing, Challenger suggested there are still attractive opportunities for property and fixed interest investments for it to maintain Life spreads within its long term target range of 4% to 5%. Over the past several months, Challenger has seen relatively attractive risk premiums on property relative to historic levels. This likely contributed to it investing ~A$600m in the Federation Centres shopping malls, a deal on which we understand the return was 7.4%. As such, for 4Q13, we are likely to see its weighting to property increase (due to the shopping mall investment), a marked change after increasing its asset allocation to fixed interest and cash over the past six years.

Challenger also argued there are opportunities for attractive returns from credit investments, for those groups with funding. It highlighted several recent opportunities in both corporate credit and ABS, where it suggests its returns on equity for these lending activates were in excess of 20%, aided by the sizeable margins over swap rates for the given level of credit risk. Refer to our note dated 16 June 2013, Challenger Ltd (CGF.AX) - Long term story sounds good, but shorter term may be tougher for more details on this.

Forecasting slightly stronger funds management flows in 4Q

Funds management net inflows of A$1.2bn were relatively strong for the March quarter, up 91% on pcp. With the June quarter a seasonally strong period for flows, we forecast A$1.3bn of net inflows for the quarter, or A$4.7bn of net inflows for FY13E. Despite continuing strength in Fidante's funds management flows, we continue to see the main issue as turning these into meaningful profit contribution.

Figure 5. Funds Management net flows

Analysis of flows	31 Mar 2012	31 Dec 2012	31 Mar 2013	Change vs. pcp	Change over quarter
	A$m	A$m	A$m	%	%
Fidante Partners	614	2,110	1,176	91.5%	-44.3%
Aligned Investments	31	-323	56	80.6%	-117.3%
Net flows	**645**	**1,787**	**1,232**	**91.0%**	**-31.1%**

Source: Company Reports

Earnings changes

We make the following changes to our earnings forecasts for Challenger:

Figure 6. Changes to Citi EPS estimates for Challenger

	FY13E			FY14E			FY15E		
	Old	**New**	**Change**	**Old**	**New**	**Change**	**Old**	**New**	**Change**
EPS (cents)	70.1	75.3	7.4%	59.9	60.0	0.2%	55.1	55.2	0.3%
Normalised EPS (cents)	56.3	56.3	0.0%	59.9	60.0	0.2%	55.1	55.2	0.3%

Source: Citi Research Forecasts

These changes are primarily the result of:

- Marking to market our Life forecasts to 30 June; and
- Marking to market our Funds Management FuM forecasts to 30 June.

Full details of our earnings forecasts can be found in our detailed financial summary towards the back of this note.

Valuation and target price

Reflecting the changes to our forecasts above, our valuation stays at A$4.35ps. Our current sum-of-the-parts valuation is shown in Figure 7 below:

Figure 7. Citi spot valuation of Challenger

Sum of parts valuation	**A$m**	**A$ps**
Funds Management	236	0.44
Life	2,487	4.69
Corporate net costs	-517	-0.97
Group net cash, post buyback	106	0.20
Total value	**2,311**	**4.35**
Shares on issue	531	
Value per share	**$4.35**	

Source: Company Reports and Citi Research Estimates

We make no change to our target price, maintaining it at A$4.10.

Summary and recommendation

Our forecasts suggest Challenger is trading on a relatively inexpensive multiple and the realisation of positive catalysts could see the stock rise materially. However, at the moment, we see significant catalysts as hard to identify. While we expect it to meet, if not slightly beat, its Life COE guidance for FY13E, this is likely mostly already expected by the market. We also see some risk it will fail to achieve its FY13E book growth guidance which may have been marginally lowered (from 8% to 7.5%) at its investor briefing in June.

However, we see FY14E guidance as potentially more important, noting that our FY14E EPS forecasts already appear to be a little above consensus, which may have more to do with diluted share count than anything else. We see some risk that our FY14E Life spread contraction forecasts are too conservative, as although the

analysis we present in this report suggests forecasting a further narrowing is logical, there is the possibility that Challenger has been able to invest in assets that limit this to some degree. Even so, we feel it appropriate to be cautious for now, albeit we are already forecasting spread contraction in FY14E to be significantly lower than in FY13E.

However, just as we are slightly concerned that there may be upside risk to our Life spread forecasts, this is not certain and we are also concerned that we may be too optimistic on retail book growth. There looks little in the near term to materially accelerate book growth from the 7.5% targeted for FY13E. In time the lengthening duration of the book should help, but this is unlikely to have a significant near term impact. Liquid lifetime and Care annuities may add a little to sales, but are unlikely to be sufficient to offset the drag on sales from lower interest rates, while Deferred Lifetime Annuities are a much longer term proposition. This suggests that net of the run off of the annuity associated with the transfer of the High Yield Fund in March 2014, which we estimate being at least A$300m, there is risk that book growth could be sub 5% in FY14E. This is lower than we currently forecast and presents downside risk to our FY14E estimates.

So even though Challenger looks to be trading on a low p/e multiple (we estimate the normalised FY13E multiple is 8.4x after adjusting for the ~A$30m tax benefit) and therefore remains vulnerable to positive catalysts, including greater investor understanding and therefore less inherent scepticism, we still believe evidence of spread stability and some comfort over FY14E book growth are likely to be required for the stock to materially further advance. We therefore maintain our Neutral call, with no change to our A$4.10 target price.

Detailed financial summary

Figure 8. Detailed financial summary

Year ended 30 June

Income statement - Statutory AIFRS (A$m)	FY11A	1H12A	2H12A	FY12A	1H13A	2H13E	FY13E	FY14E	FY15E
Life	349	177	191	368	190	191	381	392	399
Funds Management	20	10	12	21	13	15	28	32	35
Continuing normalised divisional EBIT	**369**	**186**	**203**	**389**	**203**	**206**	**409**	**424**	**434**
Mortgage Management - sold	0	0	0	0	0	0	0	0	0
Normalised divisional EBIT	**369**	**186**	**203**	**389**	**203**	**206**	**409**	**424**	**434**
Interest payable on corporate debt / interest received	2	4	2	6	1	0	1	0	0
Net corporate costs (incl LTIP)	-60	-31	-29	-59	-28	-29	-57	-58	-60
Normalised pre-tax profit	**311**	**159**	**176**	**335**	**175**	**177**	**352**	**366**	**374**
Investment earnings market adjustment	-41	-145	-50	-195	100	39	139	0	0
Pre-tax profit	**270**	**14**	**126**	**140**	**275**	**216**	**491**	**366**	**374**
Tax expense on normalised profit	-63	-32	-6	-38	-26	-27	-53	-55	-86
Investment earnings market adjustment tax expense	12	38	9	47	-27	-12	-39	0	0
Core earnings after tax	**219**	**20**	**129**	**149**	**222**	**178**	**400**	**311**	**288**
One-off items (after tax):									
Restructuring	0	0	0	0	0	0	0	0	0
One off tax benefit	42	0	0	0	0	0	0	0	0
Acquisition of CKT									
Total one-off items (after tax)	**42**	**0**	**0**	**0**	**0**	**0**	**0**	**0**	**0**
Profit after tax and one offs	**261**	**20**	**129**	**149**	**222**	**178**	**400**	**311**	**288**
Normalised core profit after tax	**248**	**127**	**170**	**297**	**149**	**150**	**299**	**311**	**288**
Core earnings used in diluted EPS calculation	219	20	129	149	222	178	400	311	283

Note: Pre-tax profit may differ to that displayed in the front of this note due to one-offs being excluded in these figures.

Balance sheet (A$m) - ex SPV, CDI and minorities	FY11A	1H12A	2H12A	FY12A	1H13A	2H13E	FY13E	FY14E	FY15E
Cash & receivables	404	564	426	426	517	808	808	965	1,077
Life investments	8,024	8,407	9,483	9,483	9,915	10,032	10,032	10,869	11,751
Property, plant & equipment	19	19	18	18	16	16	16	16	16
Goodwill	519	519	519	519	520	509	509	489	470
Other investment assets	44	38	7	7	8	8	8	8	9
Other assets	431	510	603	603	531	506	506	456	406
Tax assets	0	0	0	0	0	0	0	0	0
Total assets	**9,440**	**10,057**	**11,058**	**11,058**	**11,506**	**11,879**	**11,879**	**12,804**	**13,729**
Creditors & other liabilities	282	240	239	239	275	279	279	297	313
Policyholder & external unitholders' liabilities	6,946	7,512	8,404	8,404	8,597	8,839	8,839	9,537	10,258
Borrowings	652	640	672	672	676	678	678	681	684
Provisions	72	48	50	50	131	131	131	131	131
Other	0	0	0	0	0	1	0	0	0
Total liabilities	**7,952**	**8,439**	**9,366**	**9,366**	**9,679**	**9,928**	**9,928**	**10,647**	**11,387**
Net assets	**1,488**	**1,618**	**1,692**	**1,692**	**1,827**	**1,951**	**1,951**	**2,157**	**2,341**
Share capital	1,101	1,339	1,313	1,313	1,314	1,314	1,314	1,314	1,314
Reserves	180	97	109	109	33	33	33	33	33
Retained earnings	207	182	270	270	481	605	605	812	996
Total shareholders' equity	**1,488**	**1,618**	**1,692**	**1,692**	**1,827**	**1,952**	**1,952**	**2,158**	**2,342**
Net tangible assets	**970**	**1,099**	**1,173**	**1,173**	**1,308**	**1,443**	**1,443**	**1,669**	**1,872**

Source: Company Reports and Citi Research Estimates

Figure 9. Detailed financial summary

Divisional EBIT	FY11A	1H12A	2H12A	FY12A	1H13A	2H13E	FY13E	FY14E	FY15E
Life									
Cash spread earnings	355	189	203	392	207	209	415	431	444
Normalised capital growth	46	22	22	44	19	18	37	37	36
Life cash operating earnings ("CoE")	**401**	**211**	**225**	**436**	**225**	**227**	**452**	**468**	**480**
Personnel expenses	-28	-19	-19	-37	-20	-20	-40	-43	-46
Other expenses	-24	-15	-15	-31	-16	-16	-31	-33	-35
Normalised EBIT	**349**	**177**	**191**	**368**	**190**	**191**	**381**	**392**	**399**
Funds Management									
Boutique income	22	11	12	23	14	16	30	35	39
Equity accounted profits	8	3	6	9	5	5	10	12	14
Boutique net income	**30**	**15**	**18**	**32**	**19**	**21**	**40**	**48**	**53**
Net management fees	49	21	22	43	22	20	42	40	41
Transaction and performance fees	10	4	4	8	5	4	9	10	11
Aligned net income	**59**	**25**	**26**	**51**	**26**	**25**	**51**	**50**	**52**
Total net income	**88**	**40**	**43**	**83**	**45**	**46**	**91**	**98**	**105**
Employee & other expenses	-68	-30	-32	-62	-32	-31	-63	-66	-70
Normalised EBIT	**20**	**10**	**12**	**21**	**13**	**15**	**28**	**32**	**35**
Performance summary (A$m)	**FY11A**	**1H12A**	**2H12A**	**FY12A**	**1H13E**	**2H13E**	**FY13E**	**FY14E**	**FY15E**
Based on reported statutory profit after tax									
Basic EPS (¢)	54.5	4.0	24.1	28.8	41.8	34.0	75.9	60.5	56.6
PER (x)	7.8	53.4	8.8	14.9	5.1	6.3	5.6	7.1	7.5
Fully diluted EPS (¢)	50.7	3.8	23.8	27.8	41.5	33.8	75.3	60.0	56.2
PER (x)	8.4	56.2	9.0	15.3	5.1	6.3	5.7	7.1	7.6
Growth over pcp (%)	*-2%*	*-84%*	*-13%*	*-45%*	*993%*	*42%*	*170%*	*-20%*	*-6%*
Based on statutory core earnings after tax									
Basic EPS (¢)	42.5	3.8	23.8	27.8	41.5	33.8	75.3	60.0	56.2
PER (x)	10.0	56.2	9.0	15.3	5.1	6.3	5.7	7.1	7.6
Fully diluted EPS (¢)	**42.5**	**3.8**	**23.8**	**27.8**	**41.5**	**33.8**	**75.3**	**60.0**	**55.2**
PER (x)	10.0	56.2	9.0	15.3	5.1	6.3	5.7	7.1	7.7
Growth over pcp (%)	*11%*	*-84%*	*22%*	*-35%*	*993%*	*42%*	*170%*	*-20%*	*-8%*
PE Rel (All Ords.) (x)	0.8	4.4	0.7	1.2	0.4	0.5	0.4	0.6	0.6
Based on normalised core earnings after tax									
Fully diluted EPS (¢)	**48.1**	**24.1**	**31.5**	**55.7**	**27.8**	**28.6**	**56.4**	**60.0**	**55.2**
PER (x)	8.9	8.9	6.8	7.7	7.7	7.5	7.6	7.1	7.7
Growth over pcp (%)	*11%*	*2%*	*29%*	*16%*	*16%*	*-9%*	*1%*	*6%*	*-8%*
Dividend data	**FY11A**	**1H12A**	**2H12A**	**FY12A**	**1H13A**	**2H13E**	**FY13E**	**FY14E**	**FY15E**
DPS (¢)	16.5	7.5	10.5	18.0	9.5	10.0	19.5	20.0	20.0
Yield (%)	3.9%	1.8%	2.5%	4.2%	2.2%	2.3%	4.6%	4.7%	4.7%
Franking (%)	0%	0%	0%	0%	0%	0%	0%	0%	20%
Payout ratio (%)	31%	207%	45%	126%	23%	30%	26%	34%	36%
Group cost to income ratio	36.5%	37.3%	34.5%	35.9%	34.8%	34.6%	34.7%	34.8%	35.6%

Source: Company Reports and Citi Research Estimates

Figure 10. Detailed financial summary

Stock information			
Recommendation			**Neutral**
Market cap. (A$m)			2,300
Market cap. (US$m)	USD:AUD	0.92	2,108
Current price (A$ per share)			$4.27
Average daily volume (m shares)			2.793
Valuation data			
Citi valuation per share			$4.35

Valuation		
Sum of parts valuation	**A$m**	**A$ps**
Funds Management	236	0.44
Life	2,487	4.69
Corporate net costs	-517	-0.97
Group net cash, post buyback	106	0.20
Shares on issue	531	
Value per share	**$4.35**	

Gearing % (excludes non-recourse debt)	FY11A	1H12A	2H12A	FY12A	1H13A	2H13E	FY13E	FY14E	FY15E
Debt/(debt + equity)	24.5%	22.2%	21.0%	21.0%	20.5%	19.5%	19.5%	18.0%	16.8%
Net debt/ (net debt + equity)	20.7%	13.5%	17.4%	17.4%	15.6%	3.2%	3.2%	-2.4%	-5.3%
Price to book/NTA	**FY11A**	**1H12A**	**2H12A**	**FY12A**	**1H13A**	**2H13E**	**FY13E**	**FY14E**	**FY15E**
Price to book (x)	1.4	1.5	1.4	1.4	1.3	1.2	1.2	1.0	0.9
Price to NTA (x)	2.2	2.1	2.0	2.0	1.8	1.6	1.6	1.3	1.2
Assets under management/administration (A$m)	**FY11A**	**1H12A**	**2H12A**	**FY12A**	**1H13A**	**2H13E**	**FY13E**	**FY14E**	**FY15E**
Life assets backing annuity obligations	8,387	8,709	9,773	9,773	10,170	10,288	10,288	11,124	12,006
Boutique partnerships FuM	14,848	16,244	19,251	19,251	23,984	27,142	27,142	29,928	33,000
Aligned and other FuM	8,760	11,477	11,766	11,766	11,351	11,751	11,751	11,910	12,072
Total funds under management	**23,608**	**27,721**	**31,017**	**31,017**	**35,335**	**38,892**	**38,892**	**41,838**	**45,072**
Less double count	-4,086	-6,863	-7,361	-7,361	-7,221	-7,157	-7,157	-7,157	-7,157
Group AuM/administration	**27,909**	**29,567**	**33,429**	**33,429**	**38,284**	**42,023**	**42,023**	**45,805**	**49,921**

Shareholder information		Other	
Major Shareholders at 1 July 2013		**DRP (discount):**	No (No)
NAB	5.5%	**Index weightings**	
Caledonia	5.3%	All Ords	0.2%
UBS	5.0%	Diversified Financials	6.8%
LSV Asset Management	5.2%	Insurance	3.7%

Source: Company Reports and Citi Research Estimates

Figure 11. Detailed financial summary

Capital structure	FY11A	1H12A	2H12A	FY12A	1H13A	2H13E	FY13E	FY14E	FY15E
No. shares on issue (m)									
B/f no. of shares	499.6	496.7	552.2	496.7	544.7	538.7	544.7	530.9	522.4
Issue of shares for LTIP, CPP and CPH	14.8	65.0	0.0	65.0	0.0	2.0	2.0	4.0	4.0
Other (DRP and buyback)	-17.7	-9.5	-7.5	-17.0	-6.0	-9.8	-15.8	-12.5	-6.7
C/f no. of shares	**496.7**	**552.2**	**544.7**	**544.7**	**538.7**	**530.9**	**530.9**	**522.4**	**519.7**
Dilution for options/treasury shares	105.0	21.2	20.1	20.1	20.1	20.1	20.1	20.1	20.1
Diluted shares on issue	**601.7**	**573.4**	**564.8**	**564.8**	**558.8**	**551.0**	**551.0**	**542.5**	**539.8**
Weighted ave. basic	479.4	500.5	532.5	516.5	531.4	522.5	526.9	514.4	508.8
Weighted ave. diluted	515.8	526.8	539.6	533.3	535.0	526.5	530.7	518.4	512.8

Consolidated profit and loss account (A$m)	FY11A	1H12A	2H12A	FY12A	1H13A	2H13E	FY13E	FY14E	FY15E
Normalised capital growth	46	22	22	44	19	18	37	37	36
Normalised COE	**401**	**211**	**225**	**436**	**225**	**227**	**452**	**468**	**480**
Net fee income	88	40	43	83	45	46	91	98	105
Other Income	5	5	4	9	3	3	6	5	5
Net income	**494**	**255**	**273**	**528**	**274**	**275**	**549**	**571**	**591**
Expenses									
Employee expenses	-124	-63	-66	-129	-65	-65	-131	-136	-144
Other expenses	-56	-32	-28	-60	-30	-31	-61	-64	-67
Total expenses	**-180**	**-95**	**-94**	**-189**	**-96**	**-96**	**-192**	**-200**	**-211**
Normalised EBIT	**314**	**160**	**178**	**338**	**178**	**179**	**357**	**371**	**379**
Interest expense / interest received	-3	-1	-2	-3	-3	-3	-5	-5	-5
Discontinued operations	0	0	0	0	0	0	0	0	0
Normalised profit before tax	**311**	**159**	**176**	**335**	**175**	**177**	**352**	**366**	**374**
Tax	-63	-32	-6	-38	-26	-27	-53	-55	-86
Normalised profit after tax	**248**	**127**	**170**	**297**	**149**	**150**	**299**	**311**	**288**
Investment experience	-29	-107	-42	-148	73	27	101	0	0
Significant items	42	0	0	0	0	0	0	0	0
Net profit after tax	**261**	**20**	**129**	**149**	**222**	**178**	**400**	**311**	**288**

Source: Company Reports and Citi Research Estimates

Challenger Ltd

Company description

Challenger was incorporated in 2003 and consists of the Challenger Life Company, representing the bulk of the group's earnings, and a small Funds Management division. Challenger Life specialises in annuities and other guaranteed products, with earnings based on investment spreads.

Investment strategy

We rate Challenger Neutral (2). Challenger's main operating division, Challenger Life, has a business model that is unique in the industry - a spread business that has found a cheap source of funding through retirement income annuities, however current low yields are presenting headwinds slowing sales growth. Management is focused on expanding both products and distribution offered by the Life company. Challenger faces higher capital requirements from APRA's LAGIC proposals, although it has also obtained transitional arrangements from the regulator. The Funds Management business has significant operational leverage to markets and net flows.

Valuation

We use several methods to arrive at our A$4.10 target price. We use a sum-of-the-parts methodology to value the group overall. We set our target price at a discount to our 12-month roll-forward sum-of-the-parts valuation to reflect Challenger's lack of EPS momentum and potential headwinds from falling interest rates. We use a capitalised earnings approach to arrive at values for Challenger's operating divisions, making the adjustment for Challenger Life of deducting anticipated excess capital post LAGIC and the earnings associated with it, then adding it back at face value. We also use a capitalisation of earnings methodology to value the group.

Risks

We highlight the following risks that could cause the share price to fail to reach or exceed our target price:

- The asset/liability mismatch in the Life business model is considerable. The interest of shareholders in this division is effectively that of a third-tier creditor, after obligations to annuitants and debt holders. Future demand for new annuities is uncertain given current regulatory and tax reviews.

- Pricing for higher capital requirements may make segments of Challenger's annuity product offerings uncompetitive with bank term deposits. This appears to be happening for the shortest duration annuities.

- Earnings in Funds Management are dependent on Funds under Management (FuM), which is impacted by equity market levels and volatility. Challenger is in the middle of transitioning this division's business model to a "house of boutiques".

- Longer term, we see sales potential from deferred lifetime annuities (DLAs), following the Federal Government's proposed tax concessions, although demand for DLAs at this stage is uncertain.

Appendix A-1

Analyst Certification

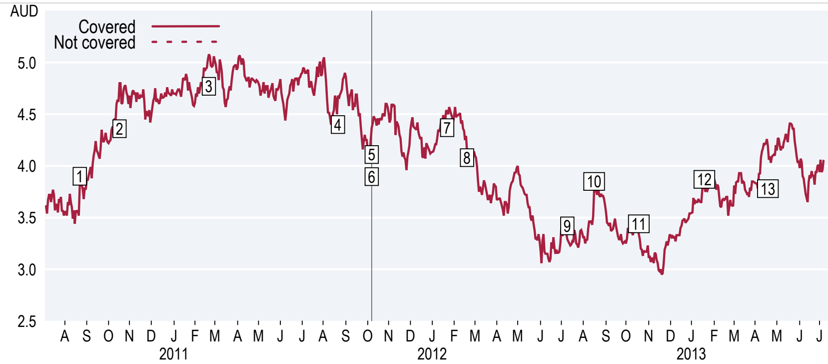
The research analyst(s) primarily responsible for the preparation and content of this research report are named in bold text in the author block at the front of the product except for those sections where an analyst's name appears in bold alongside content which is attributable to that analyst. Each of these analyst(s) certify, with respect to the section(s) of the report for which they are responsible, that the views expressed therein accurately reflect their personal views about each issuer and security referenced and were prepared in an independent manner, including with respect to Citigroup Global Markets Inc and its affiliates. No part of the research analyst's compensation was, is, or will be, directly or indirectly, related to the specific recommendation(s) or view(s) expressed by that research analyst in this report.

IMPORTANT DISCLOSURES

Challenger Ltd (CGF.AX)

Ratings and Target Price History
Fundamental Research

Analyst: Nigel Pittaway



	Date	Rating	Target Price	Closing Price
1	23-Aug-10	1H	*4.50	3.81
2	18-Oct-10	*2H	*5.00	4.80
3	21-Feb-11	2H	*5.35	5.08
4	22-Aug-11	*1H	*5.75	4.68
5	7-Oct-11	Stock rating system changed		
6	7-Oct-11	*1	5.75	4.37
7	23-Jan-12	1	*5.45	4.52
8	20-Feb-12	*2	*4.40	4.14
9	10-Jul-12	2	*3.50	3.29
10	16-Aug-12	*1	*4.30	3.76
11	18-Oct-12	*2	*3.50	3.34
12	18-Jan-13	2	*3.85	3.80
13	18-Apr-13	2	*4.10	4.19

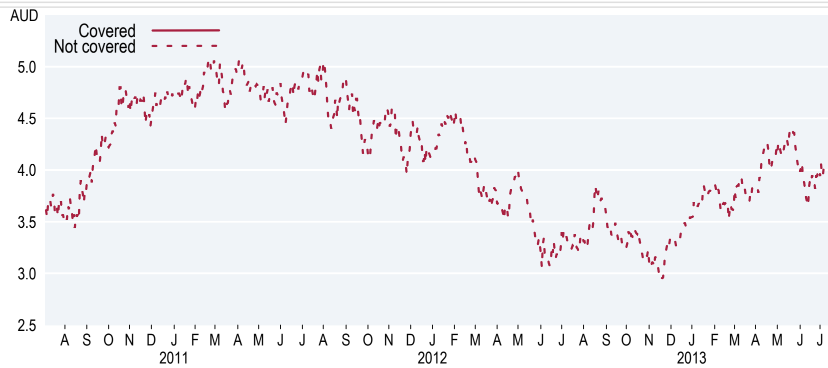
* Indicates change

Rating/target price changes above reflect Eastern Standard Time

Challenger Ltd (CGF.AX)

Ratings and Target Price History
Best Ideas Research
Relative Call (3 Month)

Analyst: Nigel Pittaway



* Indicates change

Rating/target price changes above reflect Eastern Standard Time

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Citi Research Equity Ratings Distribution

	12 Month Rating			*Relative Rating*		
Data current as of 30 Jun 2013	**Buy**	**Hold**	**Sell**	**Buy**	**Hold**	**Sell**
Citi Research Global Fundamental Coverage	48%	40%	12%	6%	88%	6%
% of companies in each rating category that are investment banking clients	53%	50%	45%	58%	51%	49%

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