

Equities

26 January 2012 | 8 pages

Federated Investors, Inc (FII)

Alert: 4Q Initial Take – Good Flows But EPS Miss; Maintain Sell As Stock Trading As If Normalized Rates/No Reg Reform Tail Risk

Company Update

Sell	3
Price (26 Jan 12)	US\$18.71
Target price	US\$16.00
Expected share price return	-14.5%
Expected dividend yield	5.7%
Expected total return	-8.8%
Market Cap	US\$1,941M

Price Performance (RIC: FII.N, BB: FII US)



- 4Q a mixed bag** — 4Q EPS of \$0.36 or \$0.01 below us and \$0.02 below “Street” but run rate closer to \$0.35 given 2% lower than normal tax rate. Favorably, LT flows are strong – both absolute and relative – and money markets spiked into YE; however: 1) fee waiver pressures are likely to persist well into 2012/13, putting downward pressure on consensus EPS estimates; and, 2) we do not expect decisive closure around reform. We expect mixed call on 1/27 (877-407-0782) & retain Sell rating and \$16 12-month target. Higher than forecast expenses paced the miss to our estimate. With the stock surging ~25% YTD, we believe expectations for FII are high, and unfortunately, the outlook remains mixed, and with no material improvement in the ST rate backdrop, “normalized” EPS continues to get pushed out. At 13x 2012 EPS, FII continues to trade in-line with peers despite still alive reform “tail risk” and outsized exposure to low ST rates vs. A/Ms generally.
- AUM beat on late quarter risk off trade, but underlying mix tempers revenues** — \$370B 12/31 AUM + 5% Q/Q and \$6B > forecast due mostly to \$5B overage in money markets – though much due to YE seasonality, we believe (as average missed). We understand much of the money market growth (\$10B+ accrued to government/treasury funds), intensifying fee waivers a tad. \$216M revenues in-line while \$61.9M operating income ~1.5% below forecast, resulting in 28.6% margin and down ~250 bps Q/Q despite the AUM updraft.
- LT flows look strong across the board** — To be fair, FII’s long-only business is doing well in both retail and SMA/institutional, and we expect constructive update on 1/27. In all, LT inflows totaled, \$2.2B, or 12% annualized growth, including \$700M in combined equities and \$1.3B in FI. Improving distribution + income orientation is bolstering volumes, we believe.
- Money markets mixed** — Interestingly, FII absorbed 30% of \$89M in gross fee waivers in 4Q, with the ratio trending higher last few quarters. We believe mix and yield backdrop is resulting in FII absorbing incrementally lower economics and tempering EPS leverage. Given repo rates and FOMC commentary – and money markets skewing further away from higher yielding product in 4Q, we do not see much improvement toward the negative ~\$25M quarterly net operating income impact. That said, we model material improvement into 2013, a building risk given Fed commentary on 1/25.
- Solid capital return** — Management repurchased ~560k shares in 4Q but did not declare a special dividend, the latter likely a disappointment to some investors.

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

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Figure 1. 4Q A Mixed Bag

	3Q11	4Q11 reported	4Q11 CIRA est.	Act vs Est	% Variance
Revenues:					
Investment advisory fees	139.4	138.2	139.5	-1.3	-0.9%
Administrative fees	54.9	56.8	55.2	1.6	2.9%
Other Service fees	19.0	20.2	19.7	0.5	2.7%
Investment & other income	0.7	1.1	0.8	0.4	46.9%
Total Revenue	214.0	216.4	215.2	1.2	0.6%
Expenses:					
Compensation	57.9	60.6	65.1	-4.5	-6.9%
Total Operating Costs	147.0	154.5	152.4	2.1	1.4%
Operating Income	67.0	61.9	62.8	-0.9	-1.5%
Non Operating Income/(Expense)	-5.3	-1.4	-0.7	-0.7	91.7%
Pretax Income	61.7	60.4	62.0	-1.6	-2.6%
Income Taxes	23.2	21.8	23.6	-1.8	-7.5%
Tax Rate (%)	37.7%	37.1%	38.0%	-0.9%	N/A
Income before noncontrolling interests	38.5	38.6	38.5	0.2	0.4%
Noncontrolling interest	0.2	1.7	0.2	1.5	797.6%
Net income attributable to Federated	38.3	36.9	38.3	-1.3	-3.5%
Average Fully Diluted Shares	100.7	100.3	100.6	-0.3	-0.3%
Operating EPS (FD)	\$0.37	\$0.36	\$0.37	-\$0.01	-2.7%
GAAP EPS (FD)	\$0.37	\$0.36	\$0.37	-\$0.01	-2.7%
Margins (%)					
Operating Income	31.3%	28.6%	29.2%	-0.6%	N/A
Net Income	17.3%	16.5%	17.2%	-0.7%	N/A
Compensation/Revenue	27.1%	28.0%	30.3%	-2.2%	N/A

Source: Company reports, Citi Investment Research and Analysis

Federated Investors, Inc

Valuation

We value the shares of Federated Investors using the target P/E method. Our \$16 12-month price target is derived by applying a 10.5x target P/E multiple to our 2012E EPS estimate. The 10.5x multiple is below FII's historical 14.5x FTM multiple.

Risks

Positive risks to our Sell rating include: 1) faster than expected rise in short term rate expectations, and 2) higher than expected money market volumes.

Additionally, if the impact from any of the following factors proves to be greater than we expect, the stock may have difficulty reaching our target price. If market conditions improve faster than anticipated, the stock may outperform our target.

Financial market risk — Changes in markets have a direct impact on AUM and investment advisory and services fees.

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Appendix A-1

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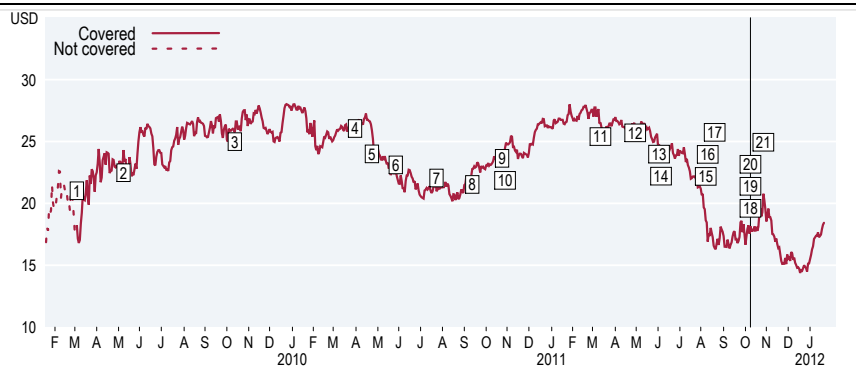
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Federated Investors, Inc (FII)

Ratings and Target Price History Fundamental Research

Analyst: William R Katz

Covered since March 31 2010



	Date	Rating	Target Price	Closing Price
1	4-Mar-09	2M	*18.00	18.24
2	8-May-09	2M	*24.00	24.31
3	13-Oct-09	2M	*26.00	25.74
4	31-Mar-10	2M	*28.00	26.38
5	23-Apr-10	2M	*27.00	25.90
6	27-May-10	2M	*24.00	22.73
7	23-Jul-10	2M	*22.00	20.98

* Indicates change

	Date	Rating	Target Price	Closing Price
8	13-Sep-10	2M	*24.00	22.78
9	25-Oct-10	2M	*26.00	24.14
10	28-Oct-10	2M	*27.00	24.48
11	11-Mar-11	2M	*26.00	26.54
12	29-Apr-11	2M	*25.00	25.78
13	2-Jun-11	2M	*24.00	24.78
14	6-Jun-11	2M	*23.50	23.99

	Date	Rating	Target Price	Closing Price
15	8-Aug-11	2M	*21.00	18.63
16	10-Aug-11	*3M	*16.00	16.91
17	19-Aug-11	3M	*15.00	16.39
18	8-Oct-11	Stock rating system changed		
19	8-Oct-11	*3	15.00	17.56
20	10-Oct-11	3	*15.50	18.15
21	27-Oct-11	3	*16.00	20.78

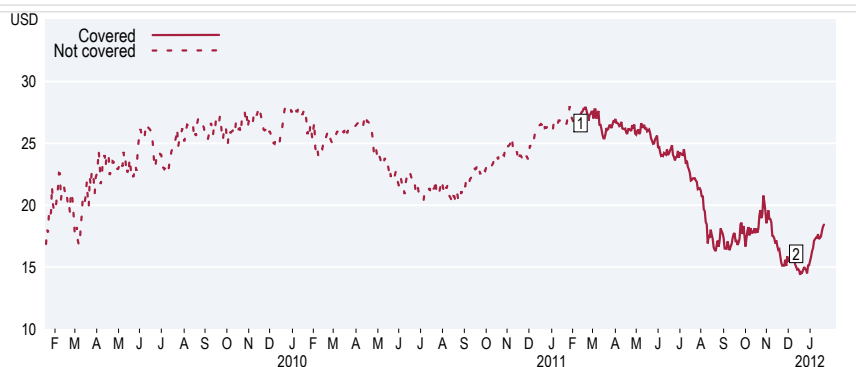
Rating/target price changes above reflect Eastern Standard Time

Federated Investors, Inc (FII)

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

Analyst: William R Katz

Covered since March 31 2010



	Date	Rating	Target Price	Closing Price
1	11-Feb-11	*ADD LP	-	27.32

* Indicates change

	Date	Rating	Target Price	Closing Price
2	13-Dec-11	*REM LP	-	15.02

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