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New Rec: Natl. Fin. Partners (NFP: \$41.98)	January 8, 2008
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Position: Sell

Target: \$25

\$000	Q4 07e	Q1 08e	Q2 08e	Q3 08e	F2007e	F2008e
Revs	362,124	348,093	317,429	384,440	1,200,534	1,474,560
EPS	0.49	0.26	0.43	0.47	1.57*	1.68
Y/Y Gr	12%	20%	-4%	17%	10%	7%
PE	n/a	n/a	n/a	n/a	26.7	25.0
PSR	n/a	n/a	n/a	n/a	1.4	1.1
Cash EPS **	0.85	0.62	0.80	0.84	2.88	3.18
Consens**	0.98	0.65	0.86	0.95	3.00	3.59

* Ex one-time charges

** Non-GAAP measure used by company as discussed below

Shares Out: 40M

Market Cap: \$1.7B

FYE: December

Summary: National Financial Partners (NFP), founded in 1998 and based in New York City, is a leading independent distributor of financial services products

primarily to high net worth individuals and companies. The company defines high net worth individuals as those who have investable assets (i.e., excluding primary residence) of greater than \$1M, although it seeks to focus on individuals with investable assets in excess of \$5M.

NFP is a rollup of independent firms that distribute life insurance and wealth transfer products (60% of sales), and that provide corporate and executive benefits to small businesses (30% of sales) and financial planning and investment advisory services (10% of sales). Jessica Bibliowicz, daughter of former Citigroup Chairman Sanford Weill, joined the firm, which had the financial backing of Apollo Management, in 1999. At that time, the company had already acquired 28 companies and had plans to acquire a total of 300 by 2004. By the end of Q3 07, NFP had bought 237 firms, of which 183 were still operating under its umbrella, and of which 80% had been acquired in the past six years.

We wonder about NFP's business model. As we shall discuss, financial results have been weak, reported earnings are of questionable quality, and recent acquisitions are getting more expensive. "Street" analysis of NFP's financials has been weak. We also take a look at the business model from the point of view of the entrepreneur who sells his/her business to NFP, something that has not been done, but which is an important exercise. As we will show in detail, it appears that only entrepreneurs who have basically weak businesses for the longer term, or those who want to retire in about three years, even if they have a good business, will be interested in the typical deal done by NFP. It appears that anyone that has a good, growing business and who plans to stay in business more than about five years would not sell to NFP. Moreover, this problem of "adverse selection" has meant that, on the average, just one of two firms acquired by NFP perform adequately. In other words, on the average, NFP has to acquire two firms to get one that will perform satisfactorily. This has important implications for the business.

Our conversations with principals who have sold to NFP suggest that they do so primarily for succession planning purposes. Most of the sellers appear to be in their fifties or older. NFP says that it attempts to retain entrepreneurship in its acquisitions by offering earnouts to principals at the third anniversary of the acquisition if they meet certain earnings growth targets, and ongoing incentives after that. However, only half of the firms that NFP has acquired have received earnouts at the end of Year 3 and only a quarter of the acquired firms have earned both the earnout at the end of Year 3 and the ongoing incentive at the end of Year 6. These data points appear to confirm the inference from our analysis of the buyout deals and conversations that independent brokers sell to NFP mainly at the sunset of their careers.

NFP acquires 100% of the equity of the acquired business and consolidates the financials of the acquired firms. The purchase price is typically about 2.5X-3X operating cash flow. Operating cash flow (OCF) is defined as cash revenues, less cash and non-cash expenses other than amortization, depreciation and owner/principal compensation. The company refers to operating cash flow as “target earnings” and calls 50% of operating cash flow “base earnings.”

Our analysis of NFP’s results suggests that annual organic gross profit growth may have declined from 27% in 2003 to an estimated –15% in 2007. NFP reports same store sales and total gross profit in any quarter, but does not report same store gross profit, which we think is a key number. Given this apparent decline in the core business, NFP has embarked on increasingly larger, costlier and riskier acquisitions to generate the appearance of growth. In the latest instance, the company paid 3.7X OCF (or target earnings) to acquire an 80% economic interest in Pro Financial Services, whose business of providing high-limit disability insurance for athletes and entertainers has little synergy with NFP’s own portfolio of businesses. This implies a price about 25%-50% higher than most previous acquisitions. So far, as noted previously, about a fifth of acquired firms have been restructured or sold, which suggests that NFP’s rollup formula and due diligence process has many poor results and points to a significant risk in the model.

In addition to the problem of previous owners losing interest in the business, an important reason why the business appears to be declining organically is that fewer high net worth individuals seem to be using certain types of life insurance as an instrument for estate planning. There was a brief boom in the life insurance business a few years ago due to the popularity of premium financing life insurance. In premium financing life insurance, third party financiers such as hedge funds pay the premiums on an insured’s policy in exchange for a portion of the settlement at the insured’ death or a portion of proceeds from a sale in the secondary market (“life settlement”). NFP benefited from this boom and same store sales grew from 6% in 2002 to 22% in 2005. In 2006, 8% of NFP’s revenue resulted from life settlement related fees, according to the 10K. However, this business has slowed down as a result of some poor outcomes, tax issues, and regulatory concerns, and NFP’s practices are under investigation by the New York Attorney General’s office.

Another sign of a weakening business model is gross margin before management fees, which has declined from 44.6% in 2004 to about 37% now. This is a result of a higher proportion of lower margin benefits business, where NFP is attempting to expand, as well as growth at NFPSI, the company’s broker dealer, where commission payouts of 90% are the norm. We note that NFP has told the “street” to expect operating expense leverage, but the decentralized structure of the company would make such a goal difficult to achieve.

As we noted earlier, 80% of NFP's firms were acquired in the past six years. Thus, the average firm was acquired just three years ago, and is therefore entering the earnout phase. Consequently, management fees, which the "street" expects will decline in the future, are actually likely to increase over the next few quarters as NFP accrues for the earnouts. Note that all earnings over base to target have an incremental management fee (from an NFP shareholder perspective) of 100%, since all the fees accrue to the firm's principal(s).

In its reporting to investors, NFP emphasizes "cash EPS," which exclude amortization, depreciation and goodwill impairment expenses, rather than GAAP earnings, and "street" analysts do not appear to object. We think this is problematic because cash earnings fail to account for bad acquisitions, which have been a recurring expense, and which therefore should not be excluded, in our opinion. As noted before, this has happened often enough for NFP to take about \$10M in annual charges over the last three years. Additionally, cash earnings do not account for the company's need for maintenance capex, which has amounted to between \$10M-\$15M per year in recent years.

The dissonance between what the company reports as cash EPS and economic reality can also be seen from the cash flow statement. Cash flow from operating activities has been steady over the past three years at about \$85M, whereas cash acquisition costs have increased from \$60M in 2004 to \$113M in 2006. As a result, free cash flow has declined from \$15M in 2004 to -\$38M in 2006. Cash outflow in 2007 should be even higher. Given the questionable nature of NFP's business model, we doubt that cash flow can improve very much. The reason is that with so few of the acquired businesses, perhaps only about 50%, continuing to grow at all, as we will discuss, and with many leaving the fold altogether, there is a need to continually acquire businesses to achieve a semblance of growth for NFP. In a steady state, without further acquisitions, we think results would be unacceptable to investors.

NFP management has said that customers tend to defer action during times of market volatility and downturn. Should the current situation in the financial markets persist and NFP's business and stock price weaken, the company's ability to acquire firms should suffer, since the company has typically paid for its acquisitions with a combination of cash (70%) and stock (30%).

The "street" expects cash EPS, as reported by the company, of \$3.59 in 2008 compared to \$3.00 in 2007. We expect this reported cash EPS to be \$3.17. If we were to value the company based on 5X 2008 gross profit ("target earnings") of \$262M, in line with what NFS has been paying all-in for its best performing acquisitions, then our price target would be \$27. Based on steady state free cash

flow, we think a fair value would be no more than 10X, given the negative organic growth, which would result in a value of \$22. If we are correct in the view that the business model is fundamentally flawed, the long-term viability of the company might be questionable and the share price could go lower still. We will set our initial target at \$25 and see what transpires.

Background:

NFP distributes financial services products (primarily life insurance) to high net worth individuals and small companies. The company targets households with investable net worth (i.e., assets, excluding primary residence) of \$1M and companies with fewer than a thousand employees.

NFP distributes life insurance products from most of the leading vendors such as AIG, AXA, John Hancock, Lincoln National, MetLife, New York Life and Pacific Life. NFP's benefit providers include United Healthcare. Competitors include captive life insurance sales organizations, banks, other independent intermediaries such as The Bisys Group, benefit brokers such as Marsh & McLennan, Aon, Arthur J. Gallagher, Brown & Brown and Willis Group Holdings, and investment management companies, brokerage firms and independent financial planners.

NFP is essentially a rollup of independent small distribution firms where the acquired firms are allowed to operate independently. The company acquires 100% of the equity of independent distributors for 2.5X-3X OCF (which is conceptually similar to EBITDA), or 5X-6X base earnings, which is about 50% of OCF. Table 1 shows the number of acquisitions made from 2002 to 2006, the earnings purchased and the multiples paid. We note that of the 237 acquisitions made by the company until Q3 07 end, 42 have since been disposed or restructured, which suggests that about a fifth of acquisitions fail.

Table 1: Details of NFP acquisitions made from 2002 to 2006

	2002	2003	2004	2005	2006
Number of acquisitions closed	26	24	19	26	23
Firms disposed of or restructured	N/a	N/a	4	11	7
Cash (\$000)	29,772	50,658	63,027	110,552	97,351
Common stock (\$000)	26,239	23,515	35,595	46,089	47,559
Other (\$000)	2,259	2,004	558	5,632	470
Total consideration paid (\$000)	58,270	76,177	99,180	162,273	145,380
Target earnings of acquired firms (\$000)	25,383	28,510	36,695	52,153	46,266
Base earnings of acquired firms (\$000)	11,674	14,180	17,948	25,655	24,583
Base earnings multiple	5.0	5.4	5.5	6.3	5.9
Portion of acquisition in cash	51%	67%	64%	68%	67%
Portion of acquisition in stock	45%	31%	36%	28%	33%

Source: Company reports

At the time of the acquisition, NFP enters into a management agreement with the principals of the acquired business. Under the management agreement, the principals are entitled to management fees consisting of all future earnings of the acquired business in excess of the base earnings up to target earnings, and a percentage of any earnings in excess of target earnings based on the ratio of base earnings to target earnings. The principals do not receive salaries.

The company retains a cumulative preferred position in the base earnings. To the extent earnings of a firm in any year are less than base earnings, in the following year NFP is entitled to receive base earnings together with the prior years' shortfall before any management fees are paid. Additional purchase consideration is often paid to the former owners based on satisfying specified internal growth thresholds over the three-year period following the acquisition. In some cases, additional purchase consideration is also paid over a shorter period.

Table 2 shows the typical earnout structure for the first three years after the acquisition. The earnout is paid out in cash and stock in proportions that vary among acquisitions. Note that this earnout does not pass through the P&L line in the income statement, but is rather capitalized as additional goodwill.

Table 2: Typical earnout structure

Average three-year earnings growth rate	Multiple of base earnings
<10%	0.0x
10%-14.99%	0.5x
15%-19.99%	1.25x
20%-24.99%	2.5x
25%-29.99%	3.0x
30%-34.99%	3.75x
>35%	5.0x

Source: Company reports

The principals retain responsibility for day-to-day operations of the firms for an initial five-year term, renewable annually thereafter by the principals. The principals are responsible for ordinary course operational decisions, including personnel, and office location, subject to the oversight of the board of directors of the acquired business. Non-ordinary course transactions require the unanimous consent of the board of directors of the acquired business, which always includes a representative of the company's management. The principals also maintain the primary relationship with clients and, in some cases, vendors.

NFP think that this structure allows principals to continue to operate in an entrepreneurial environment, while also providing the principals a significant economic interest in the business after the acquisition through the management fees. Generally, all of the company's firms must transition their financial operations to the NFP's cash management and payroll systems and the NFP's common general ledger. Additionally, principals must transition their broker-dealer registrations to, and be supervised in connection with their securities activities by, the company's broker-dealer, NFPSI.

The company requires the owners of the firms to receive a portion of the acquisition price (typically at least 30%) in the form of NFP common stock, and provides them the opportunity to receive options, additional shares of NFP common stock or cash based on their success in managing the acquired business and increasing its financial performance. The company claims to believe its structure is particularly appealing to firms whose management anticipates strong future growth and expects to stay involved with the business in the long term.

Following the third anniversary of the acquisition, principals of the acquired firms are eligible to participate in an ongoing incentive plan, which is also based on earnings growth over a three-year period (e.g., post-acquisition years 4-6). Table 3 shows the structure of payouts under this plan.

Table 3: NFP ongoing incentive plan payouts

Average three-year earnings growth rate	% of NFP's share of growth paid to principal
<10%	0%
10%-14.99%	5%
15%-19.99%	20%
20%-24.99%	25%
25%-29.99%	30%
30%-34.99%	35%
>35%	40%

Source: Company reports

In this instance, the company pay an additional cash incentive equal to 50% of the incentive award that the recipient elect to receive in NFP stock. Prior to 2005, the recipient could choose to receive 0%-100% of the ongoing incentive in stock. Since then, recipients are required to receive at least 30% and no more than 50% of their award in NFP stock.

In section 3 of this report, we will analyze what this compensation plan looks like from the point of view of entrepreneurs who sell to NFP.

Discussion:

1. Despite having missed consensus estimates four times in the past couple of years, three-quarters of the analyst following the company have a “buy” on the stock. Target price range from \$52 to \$61, or 25% to 45% above current price levels. The bulls think that after three quarters of same store sales declines, NFP has turned the corner and comps will accelerate going forward. Bulls also expect that the company’s gross margin, which has declined by more than 300 basis points in the last couple of years, will stabilize and then increase. As a result, they forecast Y/Y cash EPS growth of 19% in 2008 (to \$3.59 from \$3 in 2007) and 17% in 2009 (to \$4.18), which, in their views, justifies their price targets.

While we think that these growth expectation are unrealistic, especially given the company’ checkered record, the bigger issue, in our opinion, is that NFP’s business model appears to be flawed. The company has appeared to generate growth in unusual financial metrics such as “cash EPS,” but careful analysis of the financial results indicates that the core business may actually be declining. The company may be able to continue to show “growth” for some time by making highly priced acquisitions, but the question in our mind is whether the business model falls apart. We discuss these issues in greater detail below.

2. NFP reports same store sales growth figures for both revenues and revenues, less commission and fees (“net same store sales growth”). Table 4 shows these metrics

since the beginning of 2006. As we noted earlier, bulls were comforted by the recovery in Q3 07 and expect these comps to continue to head higher.

Table 4: Reported same store sales growth and net same store sales growth for NFP

	Q1 06	Q2 06	Q3 06	Q4 06	Q1 07	Q2 07	Q3 07
Reported same store sales growth	26.3%	14.5%	1.0%	-7.2%	-12.7%	-2.7%	6.8%
Reported net same store sales growth	19.4%	8.1%	0.0%	-10.6%	-10.2%	0.3%	10.8%

Source: Company reports

However, if we analyze same store sale growth in gross profit, a different picture emerges. In Table 5, we look at organic gross profit growth. In any given period, we assume that the base gross profit for the period is the reported gross profit plus 50% of the acquired base earnings for that period (we estimate this from the annualized figure reported by the company). This assumes that the average company is bought midway through the quarter, which is why we need to add something to gross profit. This forms the comp for the corresponding period in the next year. For quarterly periods starting with Q1 06, we then calculate the gross profit number needed for an apples-to-apples comparison. We take the period gross profit and subtract half the base earnings for the period acquired in the quarter, which, again, assumes the average company is purchased half way through the quarter, and then we subtract all the base earnings acquired for the previous three quarters. This takes out the effect of all the acquisitions made during the year. In our calculations, we assume that base earnings at the acquired firms grow at 9% annually. We think that this is reasonable, given that half of the acquired companies fail to receive earnouts, which are awarded when earning grow at least 10% annually. Note that our organic same store gross profit growth figures are well below the company's same store sale figures for most quarters.

Table 5: NFP organic gross profit growth, amounts in \$000

	Q1 05	Q2 05	Q3 05	Q4 05	Q1 06	Q2 06	Q3 06	Q4 06	Q1 07	Q2 07	Q3 07
Current Period Gross Profit	31,192	46,515	49,505	47,952	40,230	48,259	52,188	58,568	40,482	58,709	57,180
Add 50% of acquired base earnings	962	1,650	528	68	1,267	431	943	431	1,732	642	513
Gross Profit Base for next period	32,154	48,165	50,033	48,020	41,497	48,690	53,131	58,999	42,214	59,351	57,693
Current Period Gross Profit					40,230	48,259	52,188	58,568	40,482	58,709	57,180
Subtract base earnings acquired in prior twelve months					6,031	4,290	4,618	5,967	5,506	7,099	6,367
Organic Gross Profit					34,199	43,969	47,570	52,601	34,976	51,610	50,813
Y/Y organic gross profit growth					6.4%	-8.7%	-4.9%	9.5%	-15.7%	6.0%	-4.4%

Source: Company reports, OWS estimates

Table 6 shows similar calculations for annual periods from 2003 to 2007 (est.). Here we assume annual earnings growth during the earnout phase (Years 1-3 following acquisition) of 9% (as in the previous table) and subsequent annual earnings growth of 5%. We also assume that about 60% of the base earnings acquired in a given year accrue during that year. This is a reasonable assumption given that most of the acquisitions in the past five years were made in the first half of the calendar year. We note again that our calculated organic gross profit growth rates are well short of reported same store sales and net same store sales figure in recent years.

Table 6: NFP organic gross profit growth: 2003-2007e

(Amounts in \$M)	2002	2003	2004	2005	2006	2007e
Reported/estimated Gross Profit	75.4	108.1	140.4	175.2	199.2	222.0
2002 acquired Gross Profit	11.6	7.0	12.6	13.8	14.5	15.2
2003 acquired Gross Profit	14.2	8.5	15.5	16.9	17.7	18.6
2004 acquired Gross Profit	17.3		10.4	18.9	20.6	21.6
2005 acquired Gross Profit	26.3			15.8	28.7	31.2
2006 acquired Gross Profit	21.4				12.8	23.3
2007 acquired Gross Profit	37.0					22.2
Implied organic base	68.5	87.0	100.8	109.2	104.3	89.1
Y/Y change		27%	16%	8%	-4%	-15%
Reported/estimated same store sales	6%	14%	16%	22%	5%	0%
Reported/estimated net same store sales				17%	1%	2%

Sources: Company report, OWS estimates

As noted previously, the strong growth in the 2003-2005 timeframe was due in large part to the boom in premium financing life insurance business. This business has slowed substantially in the last couple of years due to regulatory scrutiny and NFP's organic gross profit declined Y/Y in 2006 and is estimated to do so in 2007. The declining organic gross profit growth implies that NFP needs to keep the acquisition machine going to show growth. If the company cannot continue its pace of acquisitions, the growth story will be over.

3. To understand why organic gross profit has been declining, we examined the decision to sell to NFP from an independent brokerage owner's perspective. Below we list various "sell"/"don't sell" payoff scenarios using the following assumptions. We assume an initial purchase price of \$6M at 3X OCF (of \$2M), base earnings/ target earnings ratio of 50%, post-acquisition OCF growth CAGR ranging from -15% to +15%, and that the owner plans to stay with NFP for 3, 6, or 9 years following the acquisition. Table 7 shows the owner payoffs for the various scenarios. While these are nominal (undiscounted) payoffs, we expect little change if we had computed the present values instead.

Table 7: Total owner draw analysis, cumulative; amounts in \$M

OCF CAGR↓ / Year →	3		6		9	
	Don't sell to NFP	Sell to NFP	Don't sell to NFP	Sell to NFP	Don't sell to NFP	Sell to NFP
15%	8.0	11.2	20.1	17.8	38.6	27.9
10%	7.3	10.1	17.0	15.1	29.9	21.6
5%	6.6	9.3	14.3	13.1	23.1	17.6
0%	6.0	9.0	12.0	12.0	18.0	15.0
-5%	5.4	8.4	10.0	10.1	14.1	11.1
-10%	4.9	7.9	8.4	8.4	11.0	8.4
-15%	4.3	7.4	7.1	7.4	8.7	7.4

Sources: Company reports, OWS estimates

In the table, the calculation shows that those owners whose results are expected to fall in the shaded area will want to sell, and in the unshaded area the NFP deal is not attractive. Obviously, the better the company, and the longer the owner wants to stay, the less attractive the NFP deal.

The conclusion to be drawn from the above analysis is that selling to NFP would most appeal to owners who plan to exit in about three years, or to those whose businesses have poor prospects. This “adverse selection” problem probably explains the negative organic gross profit growth that we have seen at NFP in the past couple of years.

4. We think the pricey acquisition of Pro Financial Services, which the company announced in September 2007 and completed subsequent to Q3 07 end supports the argument we made in the previous paragraphs. In this instance, NFP acquired an 80% economic interest in Pro Financial paying 7.3X base earnings. Thus, the principals only have a 20% stake in the business, well below the 50% norm for NFP acquisitions, and thus far less incentive to toil. Moreover, Pro Financial, a provider of high-limit disability insurance to athletes, entertainers and other highly compensated professionals, does not even appear to be an acquisition that has a high level of synergy with NFP’ current portfolio of businesses. The costliness of the acquisition suggests that the company not only cannot grow internally, but also that it has limited acquisition opportunities for its stated financial criteria.

5. Perhaps the biggest hint that NFP is not really a growth story is the use by the company of “cash EPS” and the lack of free cash flow. NFP emphasizes cash EPS in its earnings releases and conference calls, and the “street” appears to accept this figure as a proxy for earnings. Cash EPS is GAAP EPS plus pretax depreciation plus pretax amortization expense plus pretax impairments of goodwill and intangibles. The biggest concern here is that there is no adverse impact on cash EPS from expensive acquisitions or writedowns on poorly performing acquisitions. Also, cash EPS ignores the \$11M-\$15M that the company has been spending annually on maintenance capex for the past few years.

Another way to debunk the notion that cash EPS is a meaningful measure of how the company performs is to look at free cash flow. Table 8 shows free cash flow performance over since 2004. Notice the large discrepancy between FCF per share (including acquisitions & disposals) and cash EPS. Even excluding the impact of acquisitions and disposals, GAAP EPS offers a much closer approximation of FCF per share than cash EPS.

Table 8: NFP cash flow performance

	2004	2005	2006	Q1-Q3 2007
Cash flow from operating activities	86,111	87,223	81,923	44,573
Cash from disposals	-	15,567	2,429	1,920
Capital expenditures	(10,643)	(15,547)	(10,622)	(8,315)
Payment for acquired firms & contingent consideration	(60,235)	(113,109)	(112,148)	(135,339)
Free cash flow excluding acquisitions & disposals	75,468	71,676	71,301	36,258
Free cash flow (FCF) per share excluding acquisitions & disposals	2.06	1.88	1.77	0.91
Free cash flow including acquisitions & disposals	15,233	(25,866)	(38,418)	(97,161)
Free cash flow per share (FCF) including acquisitions & disposals	0.42	(0.68)	(0.95)	(2.43)
Cash EPS	1.94	2.50	2.61	2.02
GAAP EPS	1.10	1.47	1.43	0.87

Source: Company reports

6. Recent results.

In November, NFP announced results that fell far short of consensus expectations, with reported cash EPS of 75 cents far below the mean “street” estimate of 83 cents. Below in Table 9, we show Y/Y growth in both GAAP EPS and cash EPS for recent quarters. Note that the company has struggled lately to show growth even in its reported version of cash EPS.

Table 9: GAAP and “cash EPS” growth since the beginning of 2006

	Q1 06	Q2 06	Q3 06	Q4 06	Q1 07	Q2 07	Q3 07
GAAP EPS	0.24	0.34	0.41	0.44	0.21	0.26	0.40
Y/Y change	51%	6%	-7%	-18%	-9%	-24%	-2%
Cash EPS	0.52	0.64	0.66	0.79	0.53	0.75	0.75
Y/Y change	34%	11%	-5%	-5%	2%	17%	13%

Source: Company reports

The “street” was disappointed by the reported Q3 07 gross margin of 18.4%, down 117 basis points Y/Y due to higher operating expenses. The “street” did find something to cheer in the same store sales revenue growth of 6.8%, the first positive comp in four quarters. However, as we discussed earlier this is meaningless because organic gross profit, a comp that better reflects the performance of the business, was down.

At Q3 07 end, the company had \$310M in debt compared to \$89M in cash. As noted earlier, FCF per share, including acquisition expenses, was -\$2.43 for the nine months ended September 30, 2007.

7. Financial assumptions.

a. Revenues.

We expect revenue growth of 23% (or \$275M) Y/Y in 2008, resulting from the acquisition of Pro Financial (\$12.5M of OCF), \$14M of other acquired Q4 07 base earnings and an assumed \$30M of acquired base earnings in 2008.

b. Gross profit.

Since 2007 organic gross profit is expected to decline 15%, we expect a far smaller Y/Y decline of 2% in gross profit in 2008 because of the favorable comp.

c. Management fee percentage.

Table 10 shows the management fee percentages in recent quarters. Management fees as a percentage of revenues declined significantly Y/Y from Q4 06 to Q2 07. From Q4 05 to Q2 06, higher life settlement insurance sales resulted in strong earnings, which, in turn, resulted in higher management fee expenses. As growth slowed in the second half of 2006 and in H1 2007, management fees as a percentage of revenues declined sharply Y/Y in those periods and returned to levels in line with the prior year in Q3 07. In 2008, we expect management fees as a percentage of revenues to increase by 25 basis points Y/Y due to incentive accruals at firms completing three and six-year acquisition anniversaries.

Table 10: NFP management fees as % of revenue since the beginning of 2006

	Q1 06	Q2 06	Q3 06	Q4 06	Q1 07	Q2 07	Q3 07
Management fee percentage	51.8%	52.4%	50.8%	53.6%	47.3%	45.0%	51.0%
Y/Y change	521	604	89	(1,209)	(452)	(739)	24

Source: Company reports

d. Commission & fee and operating expenses.

As Table 11 shows, both commission and fee expense and operating expense have been increasing as a percentage of revenues in recent quarters. With respect to commission and fees, this is because of higher revenue growth at the company's broker dealer, NFPSI, where commissions are about 90% of revenues. The company has also been more focused on benefits related acquisitions in recent quarters and margins for these products are lower than they are for life insurance

products. In 2008, we expect commission and fee expense as a percentage of revenues to increase 50 basis points Y/Y due to a continuation of these trends.

We think the continued Y/Y increases in operating expenses as a percentage of revenues are a function of the decentralized way NFP is run. On recent conference calls, management has attempted to highlight one or two expense items unanticipated by the “street” to explain the increase in this metric. However, we think these items are simply a function of the company’s structure and that the company is unlikely to have good expense controls as long as its structure stays decentralized. In 2008, we expect a moderate 50 basis point increase in operating expense as a percentage of revenues.

Table 11: Commission & fee and operating expenses as % of revenues for recent quarters

	Q1 06	Q2 06	Q3 06	Q4 06	Q1 07	Q2 07	Q3 07
Comm. & fee expense % of revenues	33.8%	32.5%	31.8%	31.4%	33.3%	31.3%	32.7%
Y/Y change	473	599	133	562	(53)	(121)	85
Operating expense % of revenues	31.1%	28.9%	28.5%	27.7%	35.3%	31.0%	29.8%
Y/Y change	(340)	(230)	89	174	412	214	134

Source: Company reports

e. Other items.

Table 12 shows G&A expenses as a percentage of revenues for recent quarters. Note that this metric has been rising moderately for most of the recent quarters. We assume continuation of this trend in 2008 and forecast a 25 basis point increase Y/Y.

Table 12: G&A expenses as % of sales in recent quarters

	Q1 06	Q2 06	Q3 06	Q4 06	Q1 07	Q2 07	Q3 07
G&A % of sales	5.3%	4.9%	5.0%	4.1%	6.0%	5.3%	4.6%
Y/Y change	(197)	(125)	46	31	76	33	(36)

Source: Company reports

We assume amortization expense of \$38M in 2008 versus an expected \$34M in 2007 because of the higher amount spent on acquisitions in 2007. We forecast depreciation expense \$12.3M in 2008, up 13% Y/Y and in line with recent increases. We project an increase in net interest expense from an estimated \$892K in 2007 to \$2M in 2008 due to the higher level of acquisition activity in 2007 and a similar level of assumed activity in 2008. Our assumed tax rate is 42.5%, in line with the “street”.

8. Valuation.

Using the foregoing assumptions, our revenue, gross profit and cash EPS projections for Q4 07 and 2008 are shown in Table 13. The “street” does not appear to have factored in the full revenue impacts of the 2007 acquisitions, which accounts for why the average “street” revenue estimate in 2008 is higher than ours. The “street’s” 2008 gross profit estimates also don’t appear to have incorporated the effect of all the 2007 acquisitions.

Table 13: Comparison of OWS and “street” estimates for NFP

	OWS estimates	“Street” estimates
Q4 07 revenues (\$M)	362	377
Q4 07 gross profit (\$M)	66	75
Q4 07 cash EPS (\$)	0.85	0.98
2008 revenues (\$M)	1,475	1,430
2008 gross profit (\$M)	262	290
2008 cash EPS (\$)	3.18	3.59

Source: OWS estimates, “street” reports

The primary reasons for the difference between our cash EPS estimates and “street’s” estimates (even without factoring in the full impact of the 2007 acquisitions) is that we assume that organic gross profit will continue to decline in 2008 versus the “street” which assumes that organic profit will grow. Our gross margin forecast for 2008 is 18.5%, flat Y/Y with 2007, whereas the “street” assumes a 150 basis point expansion Y/Y in gross margin in 2008 to 20.5%.

We so not think that a multiple on cash EPS is the most appropriate way to value NFP, given our previously voiced skepticism of that metric. One way in which investors might value NFP is in the same manner that it values its own acquisitions. We estimate that NFP has paid about 5X OCF all-in (i.e., including earnouts and incentives) for its best performing acquisitions. If we apply such a multiple to our 2008 gross profit estimate of \$262M, we obtain an enterprise value of \$1.31B. Taking out the \$220M in net debt at Q3 07 end, we obtain a value of \$27 per share.

Alternatively, it appears that in the recent past FCF per share has been about 1.3X GAAP EPS. Applying this multiple to our 2008 GAAP EPS estimate of \$1.68 yields a 2008 FCF per share estimate of \$2.18. Given the organic decline in the business, we think a 10X multiple on projected 2008 FCF per share to obtain a share value is generous, and this yields \$22.

Longer term, we would be concerned about the company’s business model. Will its share price hold up and enable it to make acquisitions? Will it find enough companies willing to accept the type of deal offered by the company? What will happen to these acquisitions as they mature?

We set an initial price target of \$25.

9. Financial projections.

a. Quarterly projections.

	Q1 07	Q2 07	Q3 07	Q4 07e	Q1 08e	Q2 08e	Q3 08e	Q4 08e
Comm. & fee revenue	244,224	282,995	311,191	362,124	348,093	317,429	384,440	424,597
Comm. & fee expense	81,307	88,470	101,666	115,678	117,628	100,822	127,519	137,757
Operating expenses	86,131	87,767	92,794	104,069	124,503	100,033	116,558	124,146
Management fees	36,304	48,049	59,551	76,719	50,363	52,758	71,958	88,073
Total cost of services	203,742	224,286	254,011	296,466	292,494	253,613	316,035	349,976
Gross profit	40,482	58,709	57,180	65,659	55,599	63,815	68,405	74,621
G&A	14,703	14,858	14,288	15,641	21,826	17,459	18,612	19,401
Amort. Of intangibles	8,006	8,402	8,555	8,750	9,000	9,300	9,600	9,900
Goodwill impairment	1,829	1,184	2,642	3,000	3,000	3,000	3,000	3,000
Depreciation	2,468	2,642	2,855	2,900	2,950	3,000	3,100	3,200
Mgmt buyout	-	13,046	-	-	-	-	-	-
(Gain) loss on subs.	(1,583)	(401)	-	-	-	-	-	-
Total corp expenses	25,423	39,731	28,340	30,291	36,776	32,759	34,312	35,501
Income from oper.	15,059	18,978	28,840	35,368	18,823	31,056	34,093	39,120
Net interest & other	340	(333)	(399)	(500)	(500)	(500)	(500)	(500)
Income before taxes	15,399	18,645	28,441	34,868	18,323	30,556	33,593	38,620
Income taxes	6,906	8,237	12,384	14,993	7,787	12,986	14,277	16,414
Net income	8,493	10,408	16,057	19,875	10,535	17,570	19,316	22,207
Diluted shares	39,581	39,943	40,392	40,600	41,000	41,250	41,500	41,750
EPS	0.21	0.26	0.40	0.49	0.26	0.43	0.47	0.53
Cash EPS	0.53	0.76	0.75	0.85	0.62	0.80	0.84	0.92

Y/Y change

	Q1 07	Q2 07	Q3 07	Q4 07e	Q1 08e	Q2 08e	Q3 08e	Q4 08e
Comm. & fee revenue	2%	8%	17%	17%	43%	12%	24%	17%
Comm. & fee expense	1%	4%	20%	19%	45%	14%	25%	19%
Operating expenses	16%	16%	22%	21%	45%	14%	26%	19%
Management fees	-16%	-10%	11%	13%	39%	10%	21%	15%
Total cost of services	3%	5%	18%	18%	44%	13%	24%	18%
Gross profit	1%	22%	10%	12%	37%	9%	20%	14%
G&A	17%	15%	8%	24%	48%	18%	30%	24%
Amort. Of intangibles	19%	23%	20%	19%	12%	11%	12%	13%
Goodwill impairment	-25%	-61%	243%	-34%	64%	153%	14%	0%
Depreciation	16%	19%	23%	17%	20%	14%	9%	10%
Total corp expenses	5%	59%	22%	13%	45%	-18%	21%	17%
Income from oper.	-6%	-19%	-1%	12%	25%	64%	18%	11%
Net interest & other	448%	n/a	n/a	n/a	n/a	n/a	n/a	n/a
Income before taxes	-5%	-21%	-2%	7%	19%	64%	18%	11%
Income taxes	3%	-17%	-1%	2%	13%	58%	15%	9%
Net income	-10%	-24%	-2%	11%	24%	69%	20%	12%
Diluted shares	-1%	0%	0%	-1%	4%	3%	3%	3%
EPS	-9%	-24%	-2%	12%	20%	63%	17%	9%
Cash EPS	2%	18%	13%	8%	18%	5%	13%	8%

As % of sales

	Q1 07	Q2 07	Q3 07	Q4 07e	Q1 08e	Q2 08e	Q3 08e	Q4 08e
Comm. & fee revenue	100%	100%	100%	100%	100%	100%	100%	100%
Comm. & fee expense	33%	31%	33%	32%	34%	32%	33%	32%
Operating expenses	35%	31%	30%	29%	36%	32%	30%	29%
Management fees	15%	17%	19%	21%	14%	17%	19%	21%
Total cost of services	83%	79%	82%	82%	84%	80%	82%	82%
Gross profit	17%	21%	18%	18%	16%	20%	18%	18%
G&A	6%	5%	5%	4%	6%	6%	5%	5%
Amort. Of intangibles	3%	3%	3%	2%	3%	3%	2%	2%
Goodwill impairment	1%	0%	1%	1%	1%	1%	1%	1%
Depreciation	1%	1%	1%	1%	1%	1%	1%	1%
Mgmt buyout	0%	5%	0%	0%	0%	0%	0%	0%
(Gain) loss on subs.	-1%	0%	0%	0%	0%	0%	0%	0%
Total corp expenses	10%	14%	9%	8%	11%	10%	9%	8%
Income from oper.	6%	7%	9%	10%	5%	10%	9%	9%
Net interest & other	0%	0%	0%	0%	0%	0%	0%	0%
Income before taxes	6%	7%	9%	10%	5%	10%	9%	9%
Income taxes	3%	3%	4%	4%	2%	4%	4%	4%
Net income	3%	4%	5%	5%	3%	6%	5%	5%

b. Annual projections.

	2004	2005	2006	2007e	2008e
Comm. & fee revenue	639,472	891,446	1,077,113	1,200,534	1,474,560
Comm. & fee expense	163,781	247,810	348,062	387,121	483,725
Operating expenses	190,192	259,859	311,872	370,761	465,241
Management fees	145,073	208,613	217,934	220,623	263,153
Total cost of services	499,046	716,282	877,868	978,505	1,212,119
Gross profit	140,426	175,164	199,245	222,030	262,441
G&A	36,849	45,763	51,274	59,490	77,299
Amort. Of intangibles	19,550	23,709	27,984	33,713	37,800
Goodwill & intangibles impairment	4,791	8,057	10,745	8,655	12,000
Depreciation	6,658	7,815	9,136	10,865	12,250
Mgmt agreement buyout	-	-	-	13,046	-
(Gain) loss on sale of subsidiary	(145)	(6,298)	34	(1,984)	-
Total corp & other expenses	67,703	79,046	99,173	123,785	139,349
Income from operations	72,723	96,118	100,072	98,245	123,092
Net interest & other	(616)	895	1,289	(892)	(2,000)
Income before taxes	72,107	97,013	101,361	97,353	121,092
Income taxes	31,965	40,831	43,783	42,520	51,464
Net income	40,142	56,182	57,578	54,833	69,628
Diluted shares	36,640	38,345	40,403	40,129	41,375
EPS	1.10	1.47	1.43	1.37	1.68
Cash EPS	1.94	2.50	2.61	2.88	3.18
Y/Y change					
	2004	2005	2006	2007e	2008e
Comm. & fee revenue	38%	39%	21%	11%	23%
Comm. & fee expense	47%	51%	40%	11%	25%
Operating expenses	27%	37%	20%	19%	25%
Management fees	54%	44%	4%	1%	19%
Total cost of services	40%	44%	23%	11%	24%
Gross profit	30%	25%	14%	11%	18%
G&A	39%	24%	12%	16%	30%
Amort. Of intangibles	19%	21%	18%	20%	12%
Goodwill & intangibles impairment	-52%	68%	33%	-19%	39%
Depreciation	40%	17%	17%	19%	13%
Total corp & other expenses	14%	17%	25%	25%	13%
Income from operations	49%	32%	4%	-2%	25%
Income before taxes	54%	35%	4%	-4%	24%
Income taxes	37%	28%	7%	-3%	21%
Net income	71%	40%	2%	-5%	27%
Diluted shares	15%	5%	5%	-1%	3%
EPS	48%	34%	-3%	-4%	23%
Cash EPS	13%	29%	4%	10%	11%

As % of sales

	2004	2005	2006	2007e	2008e
Comm. & fee revenue	100%	100%	100%	100%	100%
Comm. & fee expense	26%	28%	32%	32%	33%
Operating expenses	30%	29%	29%	31%	32%
Management fees	23%	23%	20%	18%	18%
Total cost of services	78%	80%	82%	82%	82%
Gross profit	22%	20%	18%	18%	18%
G&A	6%	5%	5%	5%	5%
Amort. Of intangibles	3%	3%	3%	3%	3%
Goodwill & intangibles impairment	1%	1%	1%	1%	1%
Depreciation	1%	1%	1%	1%	1%
Mgmt agreement buyout	0%	0%	0%	1%	0%
(Gain) loss on sale of subsidiary	0%	-1%	0%	0%	0%
Total corp & other expenses	11%	9%	9%	10%	9%
Income from operations	11%	11%	9%	8%	8%
Net interest & other	0%	0%	0%	0%	0%
Income before taxes	11%	11%	9%	8%	8%
Income taxes	5%	5%	4%	4%	3%
Net income	6%	6%	5%	5%	5%