COMMENT

Oppenheimer an undervalued wallflower

Toronto-based investment firm bought CIBC unit

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The late comedian Rodney Dangerfield perennially complained that he didn't get any respect, and the same is true of many undervalued equities. It can take some work to find these wallflowers, but if you can see past their warts, they have appealing value.

Take **Oppenheimer Holdings Inc.**, a regional investment firm that's headquartered in Toronto and trades on the TSX, but does all its business in the United States. Oppenheimer draws more flies than brokerage analysts and has been virtually ignored by the business press since it bought CIBC's private-client and asset-management business three years ago.

We were attracted to the company because it is exactly the kind of situation that fits our mandate of providing research ideas not available from any other source. Our optimistic view is based on the company's current performance and prospects, the smart way it's re-orienting its business from retail brokerage to asset management, the intrinsic value of its assets, and the efforts it's making to prevent any dilution of its equity.

Oppenheimer's first-half earnings jumped 208% from the previous year to US$26.4-million, as a result of improved fee-based revenues, higher commissions, principal transactions and a gain on the sale of some of its shares in NYSE Group.

While the recent softening of the U.S. economy doesn't bode well for dealers generally because slower growth naturally truncates the flow of money into investments, Oppenheimer has a degree of immunity, thanks to its highly focused operations. The firm generates its largest principal trading volume from municipal bonds and has a strong niche position as a market maker in roughly 800 Nasdaq-listed and OTC Bulletin Board stocks.

The firm is also building its asset-management business, adding stability to revenue and earnings. Although Oppenheimer lost 20% of its assets under management in late 2005, when the Asia Tigers Fund moved US$2-billion over to the Blackstone Group, the firm has been rebuilding, partly by converting clients from commission to fee-based accounts.

This way, investment advisors on the retail-brokerage side of the business become portfolio managers in the asset-management area, bringing their clients' funds with them. Oppenheimer is also making gains on the asset-management side with its new proprietary WRAP product line, which combines a number of services under one fee.

Oppenheimer has added to its principal trading product line by including "riskless principal transactions," in which the firm acts as an agent on both sides of a trade. Say, for example, that a client wants a municipal bond that Oppenheimer doesn't have in inventory. The firm finds the bond, buys it, marks it up and resells it, plus commission, to the client — all without having the risk of actually holding the security.

Given its modest market capitalization — about $430-million at the current share price — Oppenheimer looks thoroughly undervalued. This summer, another regional U.S. securities dealer, Piper Jaffray Cos., completed the sale of its private-client network to UBS AG for US$750-million. Based on that deal, Oppenheimer's retail-brokerage assets alone could be worth roughly US$400-million to US$500-million, which implies that investors can get the investment-banking and asset-management sides of the business for free.

Oppenheimer has also taken advantage of its weakened share price over the past 12 months to buy back stock. In the year to July 21, the firm bought back 495,600 class A non-voting shares and says it intends to buy up to 632,000 more over the next year or so.

As well, the firm has recently eliminated a large dilution overhang by buying back US$160.8-million in variable-rate exchangeable debentures that were issued to CIBC as part of the asset-management purchase. By 2013, the exchangeable debentures would have bloated Oppenheimer's equity by another 6.9 million class A shares, an increase of more than 50%.

These various attributes have already resulted in Oppenheimer's shares gaining more than 40% since we recommended them to clients this past March. Yet, many investors remain fixated on Oppenheimer's rather minor blemishes and setbacks, rather than its overall potential. Alongside the more than 12 million class A non-voting shares available for public purchase, there are 99,680 class B voting shares, 51% of which are controlled by chairman and chief executive Albert Lowenthal.

The dual share structure is a turn off to some, but others simply see it as an opportunity to buy equity at a discount. However, the share structure is not Oppenheimer's only detraction. The company also faces some regulatory issues, including questions about the way it manages the reporting of its municipal-bond trading, and the market-timing activities of former employees in an acquired firm, Josephthal & Co. Accordingly, our valuation of the firm factors in a US$10-million reserve to cover regulatory costs in 2006.

Of course, none of these minor drawbacks would likely matter if some acquisitor eventually comes along and convinces Mr. Lowenthal to part with his voting shares. For now, however, the company appears to remain significantly undervalued.

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