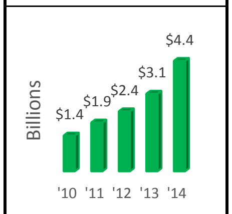
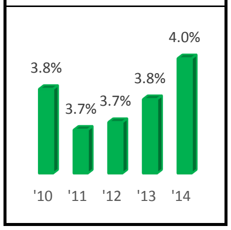
BofI Holdings
December 3, 2014

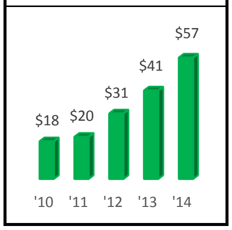
General Overview

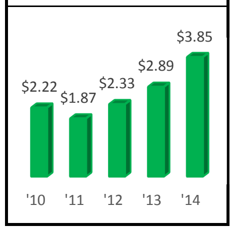
BofI Holding is the holding company of BofI Federal Bank - an online bank that focuses on providing banking services through multiple low-cost digital channels. The bank has customers nationwide and provides financing for single family and multifamily residential properties, small-to-mid size businesses, and select specialty finance receivables. In the last decade BofI has been one of the most successful banks in the nation with industry leading of cost controls, profitability, underwriting, and growth.

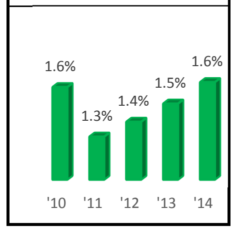
AUM	Net Interest Margin	Core Earnings	EPS	Return On Assets
$4,402,999,000	3.95%	$56,930,000	$3.85	1.59%
5-Year CAGR = 32.7%	5-Year AVG = 3.79%	5-Year CAGR = 34.1%	5-Year CAGR = 14.8%	5-Year AVG = 1.44%











Purchase Logic

The purchase logic for BofI was relatively straight forward: The company is one of the most efficient banks in the United States and continues to steal market share from the brick-and-mortar competition. In the last 5 years the business has compounded assets and core earnings at a rate in excess of 30% and continues to gain efficiencies as the business scales. These efficiencies are being passed along to customers in the form of cost savings and higher interest payments on checking accounts. We are excited about the future of the business because the key drivers of success that have allowed BofI to dominant continue to improve. With less than 0.03% of the overall market the runway for growth is long. We effectively paid 15x earnings for a rapidly growing business with a strong competitive position. This compares favorably to the average P/E multiple of 16x earnings for an S&P 500 constituent.

Key Drivers

The key drivers for BofI are Assets Under Management, Return on Average Assets, Core Earnings, Net Interest Margin, and Non-Performing Loans to Total Loans. Each driver of success is described in greater detail below.

AUM

Assets under management is the terminology used to describe the total amount of money that is being managed by the bank. As new customers deposit funds at BofI the total AUM for the bank increases. As a branchless bank BofI has been able to attract additional deposits by charging lower fees on checking accounts and offering higher interest rates. This metric is important because it is the size of the bank is a primary driver of core earnings. The larger the bank the higher the earning power.

Return on Average Assets

ROAA is an important measure of a banks efficiency and profitability. The higher the ROAA the more profitable the business. An average bank typically has a ROAA of 0.75%, whereas BofI has nearly doubled this national average for the last 5 years demonstrating a unique business model and superior execution. ROAA is calculated by dividing TTM core earnings by TTM average assets.

Example

TTM core earnings = $56 million
TTM average assets = (Beginning of period assets + End of period assets) / 2 = ($3.1B+ $4.4B) / 2 = $3.75B
ROAA = $56,000,000 / $3,750,000,000 = 1.5%

This metric is important because it is a clear indicator of how well BofI is competing relative to its peers. If ROAA is significantly higher than the competition it is a demonstration of superior performance and execution.

Core Earnings

We define core earnings as the net income without the after-tax impact of realized and unrealized securities gains and losses. In plain English, this metric is a measure of how much money the bank would earn excluding special one-time items, such as the gain on sale from investments. Core earnings are important because it ultimately determines the value of the company. The more the business earns the more the business is worth.

Net Interest Margin

The net interest margin is defined as the interest rate spread between interest earnings assets and interest bearing liabilities. If a customer receives 0.5% interest in their checking account and the bank loans those funds as a home mortgage at 4.5% the net interest margin is equal to 4.0% (4.5% - 0.5%). The net interest margin is typically dictated by market forces and is can only be slightly improved by outstanding management. This metric is important because it is a major contributor to core earnings.

Non-Performing Loans to Total Loans

Non-performing loans occur when a bank extends credit to a borrower that does not repay. It is essential that all banking institutions minimize the number of loans that end up non-performing. Historically a value less than 1% is expected for a high quality bank during normal economic conditions. During the financial crisis this number climbed as high as 5% for some banks and many were forced to declare insolvency. BofI was a notable exception during this time period. The company has consistently had one of the lowest non-performing loans to total loan ratios in the nation indicating high quality underwriting standards. Due to the rapid growth of BofI it is imperative that underwriting remains a priority. This metric is important because a bank that extends low quality loans will eventually face insolvency.

Historical Performance of Key Metrics

Year	'10	'11	'12	'13	'14	CAGR or AVG
AUM	$1,421,081,000	$1,940,087,000	$2,386,845,000	$3,090,771,000	$4,402,999,000	33%
Net Interest Margin	3.83%	3.67%	3.70%	3.79%	3.95%	3.79% (AVG)
Core Earnings	$17,600,000	$19,700,000	$30,677,000	$41,481,000	$56,930,000	34%
EPS	$2.22	$1.87	$2.33	$2.89	$3.85	14.8%
Non-Performing Loans to Total Loans	1.48%	0.72%	0.98%	0.80%	0.57%	0.91% (AVG)
ROAA	1.56%	1.26%	1.35%	1.46%	1.59%	1.44% (AVG)

AUM

Assets under management have increased from $609 million in 2005 to more than $4.4 billion in 2014. This represents total annualized growth of 24.6% or 15.1% annualized growth per share when factoring in dilution. The historical performance is largely attributed to a secular shift to branchless banking combined with attractive rates on deposits that has allowed BofI to capture market share. BofI has created an engine for new business through affinity channels, online advertising, print advertising, direct mailers, and more. This distribution engine is firing on all cylinders.

ROAA

Return on average assets has been steadily increasing as BofI has been able to leverage more assets across the company's digital platform. For the years spanning 2005 to 2009 ROAA averaged 0.5% due to the limited size of the bank and the fixed costs associated with running the banks technology platforms. As assets have increased the fixed costs have remained relatively stable allowing for strong operational leverage to lift ROAA. In the last 5 years ROAA has averaged 1.5% which is approximately double the national average.

Core Earnings

Core earnings have benefited from both the increase in AUM and the operational leverage inherent in BofI's business model. These two elements have increased core earnings from $2.8 million in 2005 to $56.9 million in 2014 representing a 40% annualized increase or 28.6% when calculated on a per share basis. The circumstances, competitive position, secular tailwinds, and outstanding execution that contributed to this phenomenal growth remains intact today.

Net Interest Margin

Net interest margin has been steady between 3.6% and 4.0% for the last 5 years. BofI has been improving the net interest margin by attracting more low cost deposits through business checking accounts. In the last 2 years deposits from this low cost source has risen from $185 million in Q3 '13 to more than $1.7 billion in Q1 '15. Management continues to target similar avenues for low cost deposit growth including the company's recent agreement to assume between $450 million and $550 million in deposits from H&R Block at a cost of between 11 and 15 bps. These efforts should allow the bank to maintain a competitive NIM moving forward.

Non-Performing Loans to Total Loans

Non-performing loans reached their peak in 2010 at 1.48% which was significantly less than competing financial institutions during the financial crisis. During the last 10 years BofI has consistently had one of the lowest Non-Performing Loan ratios in the industry due to strong underwriting standards and large down payments on residential property. It is our expectation that BofI will maintain a ratio of less than 1%, but during times of economic recession this ratio may exceed 2% or 3%. During such turbulent times we would expect Core Earnings to drop significantly and the price of the stock to decline.

Summary of Key Metrics

Metric	Expectations
Assets Under Management	Growth ranging from 8% to 30% per year Average of 15%-20% over 5 years
Return On Average Assets	Fluctuating between 1% and 2% Average of 1.5% over 5 years
Core Earnings	Growth proportional to AUM
Net Interest Margin	Fluctuating between 2% and 4% Average slightly less than brick-and-mortar competitors
Non-Performing Loans to Total Loans	Fluctuating between 0% and 1% with an average less than 1% >2% during a recession accompanied by a large price decline in the stock price

The Moat Around The Metrics

<u>Low Cost Provider</u>

BofI's primary competitive advantage is the low cost structure of the bank. As a branchless bank the company has lower operating expenses than the brick-and-mortar competition. This branchless business model is a 'self-serve' model as opposed to a 'relationship' model. Many individuals in the United States are willing to bank online and perform all necessary banking transactions themselves, such as depositing checks using a mobile app and setting up electronic payments. These individuals are willing to bank with BofI because of lower costs (such as free check books, zero ATM fees nationwide, etc.) and higher interest rates on savings. These consumers are willing to sacrifice the 'relationship' at a branch location for cost savings.

As a low cost provider BofI has created an extensive moat around the business. Below is a snapshot of the operating costs of the company relative to 451 banking peers of similar size:

"Our Business Model is More Profitable Because Our Costs are Lower"[1]

As % of average assets	**BofI %**	**Banks $1-$10bn in Size**
Salaries and Benefits	0.71%	1.52%
Premises and Equipment	0.13%	0.36%
Other non-interest expense	0.54%	1.29%
Total non-interest expense	**1.38%**	**3.17%**

For every $100 million dollars in assets the average bank has $3.17 million in expenses compared to $1.38 million for BofI. Operating expenses at BofI are 56% less than the competition and these cost savings are passed along to customers by offering many free services and paying higher interest rates on checking and savings accounts. Many customers are attracted to this type of banking service and BofI has been rapidly gaining market share.

In addition to having a superior business model BofI also benefits from superior execution. For example, Ally Bank, a much larger online competitor has been unable to control costs and gain the same edge that BofI has established. The primary reason for BofI's dominance is an intense focus on cost controls and automation.

[1] *BOFI Investor Presentation – SEC filing 8-K*. EDGAR, 2014-12-02. Page 6.

In the most recent conference call CEO Greg Garrabrant's discussed the banks continuing efforts to become more efficient:

"…we've gone through a very substantive initiative to document, and to really hone in on every process that exist at the bank. And we've got about 1,600 processes that we've gone through and we've done a lot of work on triaging those processes to make sure that we're -- we know exactly how many times they're occurring, and whether there's efficiency opportunities, and what those efficiency opportunities are, in each process. And the amazing thing is, despite how efficient we are there are still lots of things that can not only be made more automated and also, I think, therefore, more safe and more likely to be correct from a regulatory and compliance perspective, but also more efficient."[2]

The relentless effort for efficiency is ingrained in the culture of BofI and has become a distinct competitive advantage. We believe this competitive advantage will continue to widen in the coming years as the business gains additional operating leverage and has more income available to invest in automating existing processes. In short - BofI is winning through a superior business model and excellent execution.

Risks

All banks carry risk due to the highly leverage nature of the business. As such, we intend to limit this position size to 7% of portfolio assets based on cost. Below are the primary risks we've assumed as owners of BofI.

<u>Short-Term Risks</u>

- Interest rates increase sharply. This would reduce BofI's income for 1 to 3 years due to the negative interest rate gap of the asset portfolio. A decline in income during a rising rate period would stabilize over time and management's decision to manage the asset portfolio with a negative gap is one we believe is prudent.
- Regulatory changes. BofI currently has a variety of 'niche' loans that have allowed them enjoy premium rates on the mortgages they originate. These niche loans include financing for foreign nationals or to individuals based on asset depletion underwriting standards. It is possible that regulators will scrutinize this area and make regulatory changes that would impact BofI in the short term. In the event that BofI is unable to serve these markets the NIM would compress and overall profitability decline. In this event we would still be content as owners of the business.

<u>Long-Term Risks</u>

- Poor Underwriting Standards. If BofI compromises underwriting standards for more rapid growth it could create a dangerous situation for stockholders. We have analyzed the underwriting processes for a few channels through which BofI originates loans with a primary focus on the warehouse lending lines that third-parties access for loan origination. After conducting our analysis we believe the requirements for borrowers are rigorous and intelligent. We have assumed that this sample research is consistent across all loan origination lines. Further evidence of strong underwriting standards at BofI include complaints from customers for being rejected when applying for loans (a good sign), down payments ranging from 30% to 45% on residential properties, and industry leading non-performing loan ratios for 10 straight years. If we detect that underwriting standards have deteriorated we would intend to exit the position.
- Regulatory changes. BofI continues to automate many processes that historically were done using manual documentation and inputs. If regulators force BofI to change the company's business processes to a less efficient model the company's competitive position could be negatively impacted.

[2] *BOFI Q1 2015 Conference Call* – www.seekingalpha.com

Conclusion

In conclusion we believe that we paid a fair price at 15x earnings to acquire one of the world's leading banks. BofI currently holds the title as the most efficient bank in the United States and management continues to examine business processes to eliminate inefficiencies. The cost savings for BofI are passed along to customers which has allowed them to gain tremendous market share in recent years. With $4.4 billion in AUM the bank is still relatively small and has a tremendous runway for growth. As long as management continues to execute on their low cost business model with high underwriting standards we believe BofI will continue its rapid growth into the future.

Works Cited

1) *BOFI Annual Report - SEC Filing 10-K.* EDGAR, 2013.
2) *BOFI Investor Presentation – SEC filing 8-K.* EDGAR, 2014-12-02
3) *BOFI Q1 2015 Conference Call* – http://seekingalpha.com/article/2639995-bofi-holdings-bofi-ceo-gregory-garrabrants-on-q1-2015-results-earnings-call-transcript?part=single

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