



**Genworth**  
Financial



WESTERN INVESTMENT CLUB

Genworth MI Canada (MIC)

***Buy Presentation***

*Financial Institutions Group*

Genworth MI Canada

# INVESTMENT THESIS

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***Genworth has been unfairly punished due to misconceptions about the industry and troubles with its U.S. parent. Genworth is in a strong position to claim market share and shows high upside potential from its current multiples while limiting downside risk with a strong, increasing dividend (6.3% yield).***



Genworth MI Canada

# MORTGAGE INSURANCE

*Is a risk-management product generally purchased by homeowners and/or mortgage lenders to protect mortgage lenders against a loss related to a payment default by a homeowner*



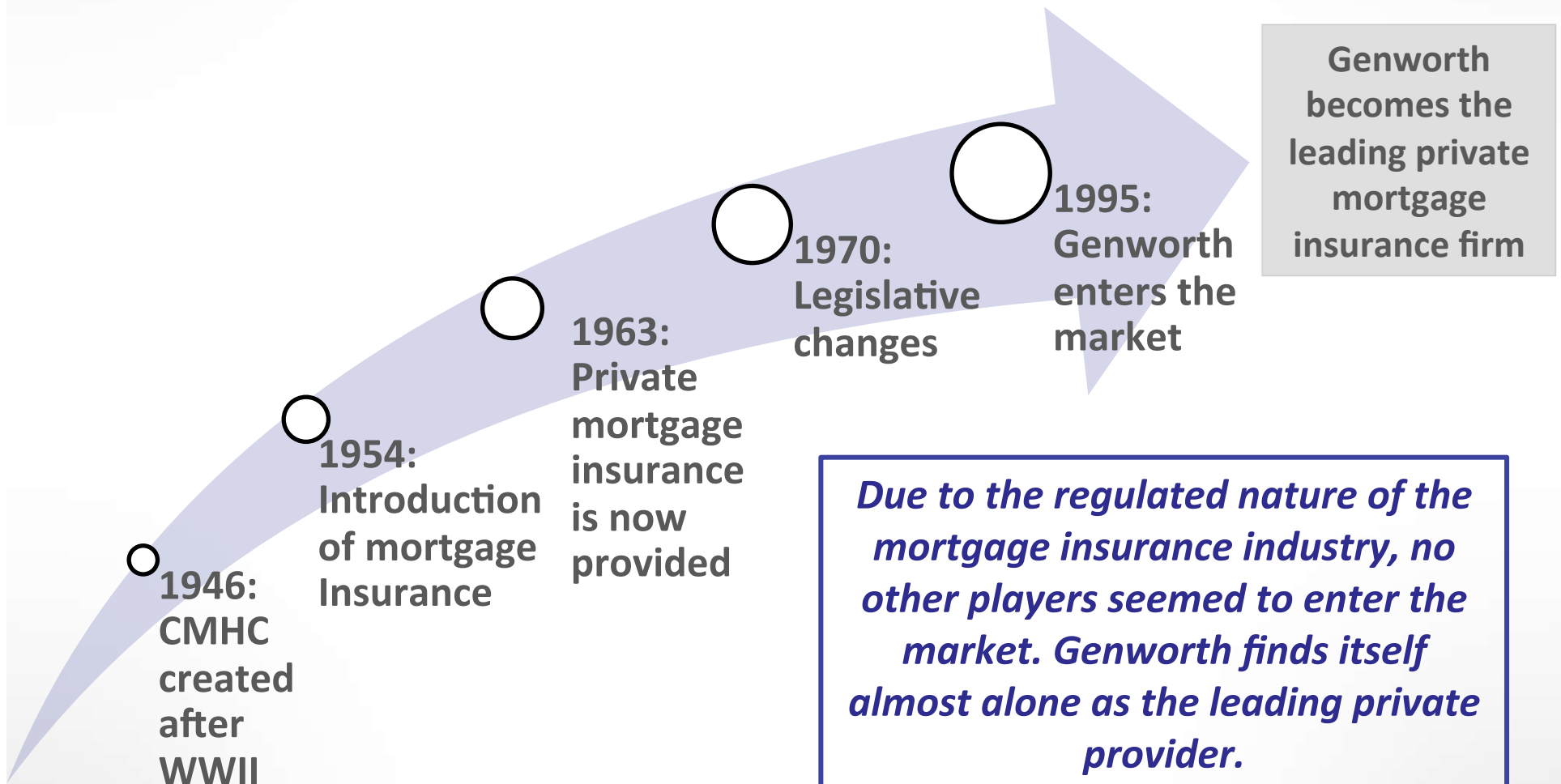
Genworth MI Canada

# INDUSTRY OVERVIEW

- Primary-flow insurance
- Bulk insurance
  - Used to attract lower capital charges
  - Improve liquidity of mortgage loan portfolios
- Guarantees on mortgage insurance
- Significant regulation



# INDUSTRY HISTORY



# INDUSTRY TRENDS

## Canadian Housing Industry

- Undoubtedly, the future of the Canadian housing market has been a hot topic within the private sector, government and the occasional dinner party
- Average house prices have increased from historical averages of 3.5x to 5.0x Income
- The capital markets have been given signs of security...
  - *“Concern would be warranted where house prices exceed levels that would be suggested by underlying demographic, economic and financial factors (migration, income, interest rates, wealth, etc.) and where the growth rate of prices is accelerating...Based on these and other characteristics, clear evidence of bubbles lacking...”*

– CMHC 2011 Annual Report

***CMHC has attempted to assuage any concerns regarding the possibility of a housing bubble in Canada***



Genworth MI Canada

# INDUSTRY TRENDS

...but still, confidence is lacking

iShares S&P/TSX Capped REIT In

■ XRE.TO

27 Nov, 2012



***S&P/TSX Capped REIT Index, a proxy of Canadian REIT performance, shows a lack of confidence in Canadian real estate***

# INDUSTRY TRENDS

## Canadian Mortgage Insurance Industry

- Two predominant players: Canadian Mortgage and Housing Corporation (CMHC) and Genworth Financial
  - CMHC currently holds a 70% market share, whereas Genworth holds the remaining 25-30%
- Genworth is the largest private mortgage insurer in Canada
  - Canada is the second largest mortgage insurance market in the world
- CMHC is reaching its mortgage insurance cap of \$600 billion
  - Has been raised twice since 2007
- CMHC has been reducing its exposure due to criticism surrounding the use of taxpayer money

***An opportunity exists for Genworth to expand market share as CMHC reduces its exposure***





# RISKS & MITIGATION

**There are many “perceived” risks associated with the investment**

- 1) The extremely high Household Debt-to-Disposable Income ratio (~155%)
- 2) Canadian consumers are borrowing at the margin, meaning that any sharp downward adjustment would send borrowers into default
- 3) Given rising commodity prices, the Bank of Canada may be obligated to raise interest rates, which would crush consumers holding massive amounts of debt
- 4) There is mass speculation in the Canadian housing market caused by foreign investors looking for quick returns

We will attempt to convince you that these worries are not well-founded...

***Are we blowing the current Canadian Housing Market situation slightly out of proportion?***

# RISKS & MITIGATION

## Traditional arguments for stability

- 1) Canada has a lower delinquency rate than the US on mortgage defaults, currently sitting pretty at 0.4%
- 2) Canada is a recourse nation as opposed to the US, which did not collateralize against mortgages in the wake of the subprime mortgage crisis
- 3) Canada does not offer tax deductibility on mortgage interest like the US, therefore there is an incentive for Canadians to pay off their mortgages as quickly as possible

But these arguments have greater flaws than we think...

***The three most popular arguments to mitigate the inevitability of a housing bubble bursting in Canada may not be that well founded***

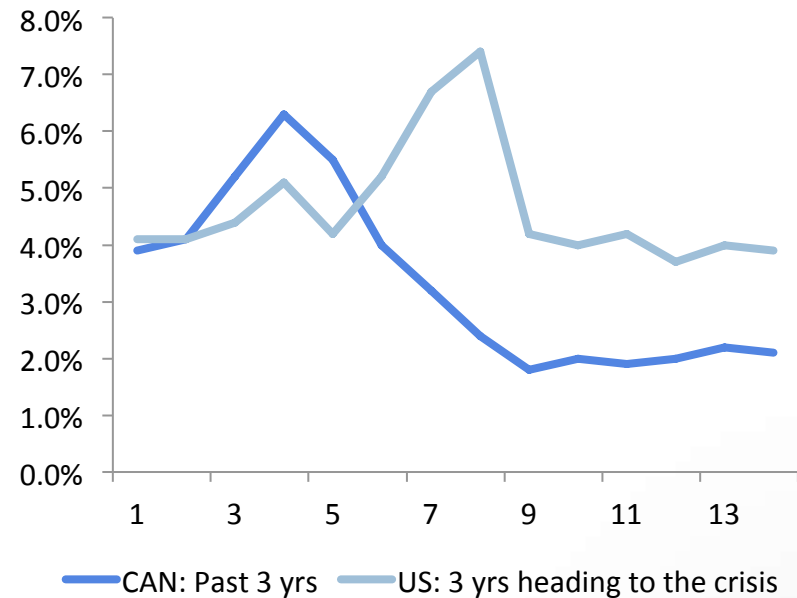


# RISKS & MITIGATION

## 1. The most discussed risk: Debt-to-Disposable Income

- View: As this ratio has increased to new heights, parallel only to that of Americans prior to the subprime mortgage crisis, fears escalate
- BUT this ratio is extremely unreliable since its relating a STOCK to a FLOW
  - Compare it to a Debt / EBITDA ratio. Would you be frightened by a 1.55x Debt / EBITDA ratio?
- We believe it makes more sense to look at the growth of this ratio
  - Here, we see a better picture...

Debt-to-Income Growth (%)

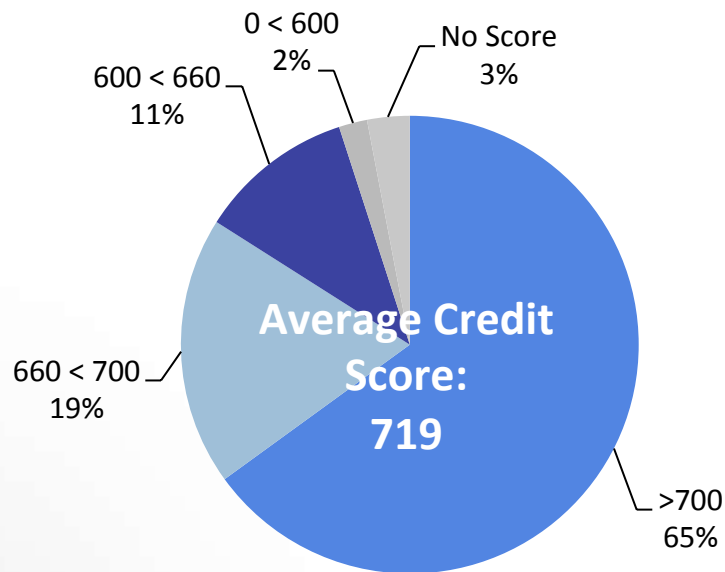


***Debt-to-Income is mainly a “headline grabber”***

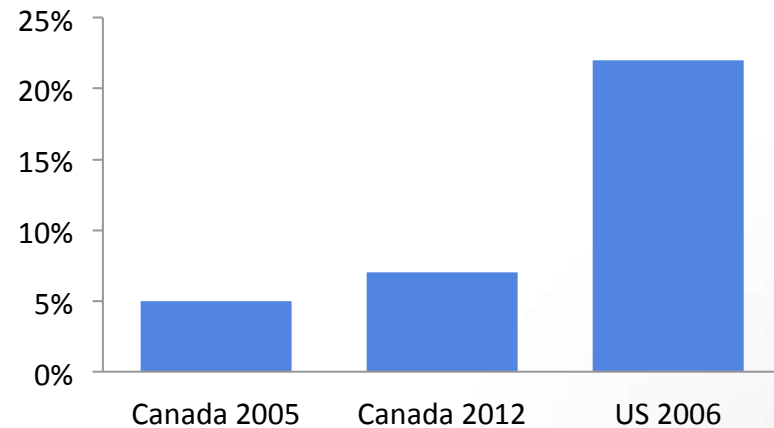
# RISKS & MITIGATION

## 2. Consumers are borrowing at the margin

- The characteristics of the Canadian borrower bring us comfort
  - Canadian credit scores are extremely high and the proportion of subprime mortgages are low



## Non-Conforming Mortgages as a % of Outstanding Mortgages

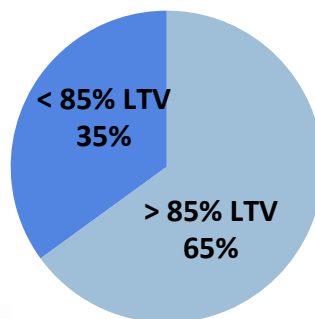


# RISKS & MITIGATION

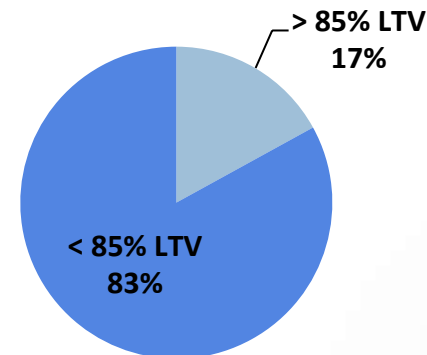
## 2. Consumers are borrowing at the margin

- In the US, 33% of mortgage originations in 2005/2006 were in a negative equity position (before the drop in prices), and more than half had a < 5% equity position
- Currently in Canada, there are no negative equity position mortgages and only 15-20% of originations have a less than 15% equity position

**Outstanding Mortgages  
(US 2006)**



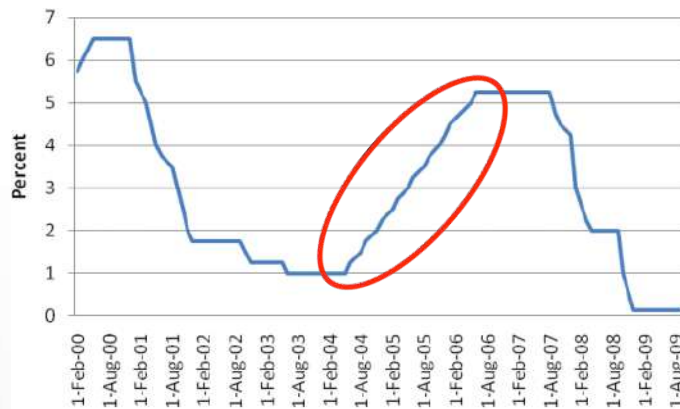
**Outstanding Mortgages  
(Canada Q2 2012)**



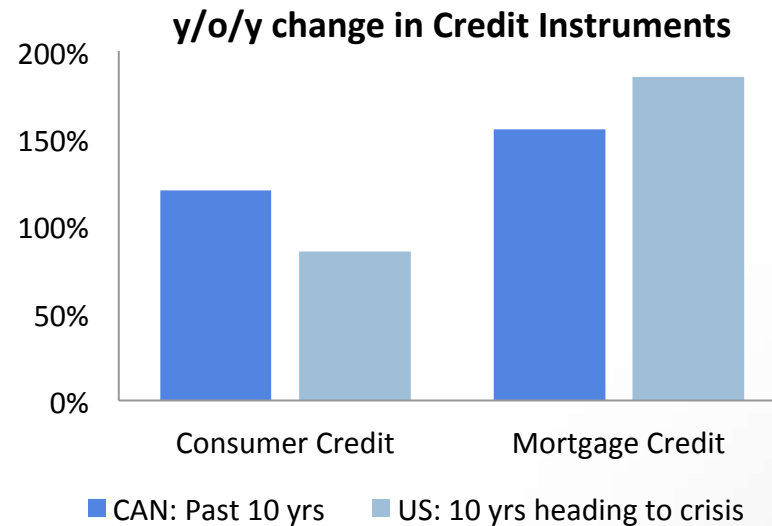
# RISKS & MITIGATION

## 3. Interest rate hikes will sink the boat

- Canada does not have teaser rates, similar to how they did in the US
  - Huge adjustments for home borrowers in the US when “honeymoon” period ended
- Canadian consumers typically lean on other credit instruments and not so much on mortgage credit

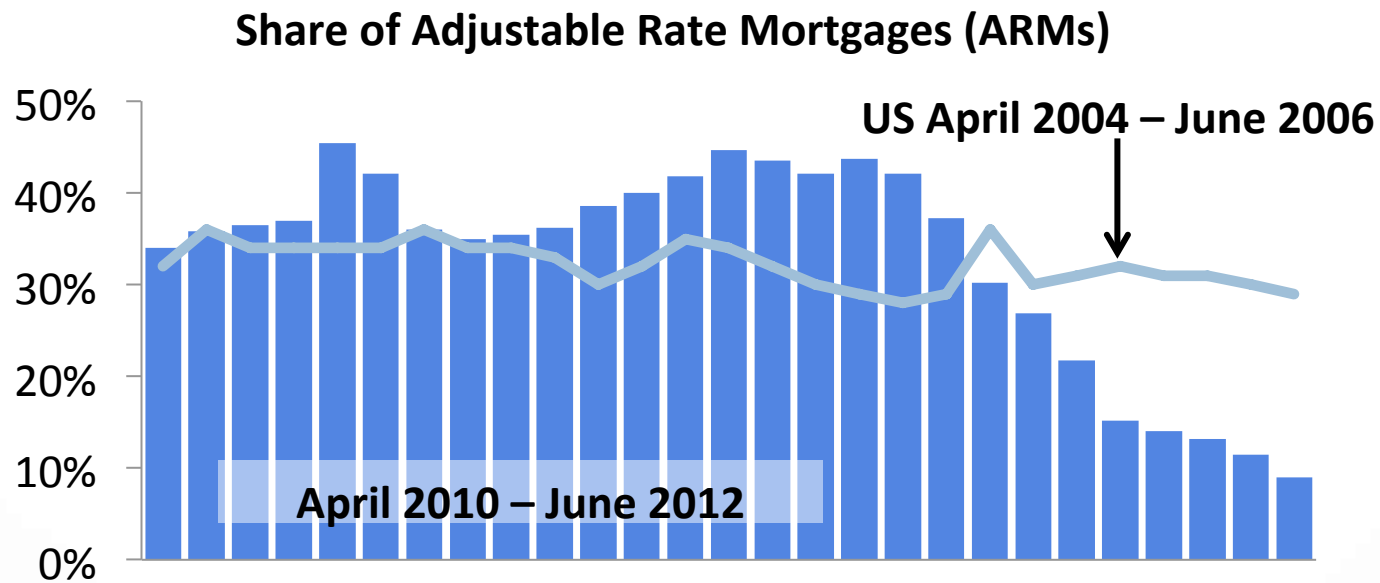


Source: Federal Reserve Board



# RISKS & MITIGATION

## 3. Interest rate hikes will sink the boat



Source: CIBC Economics

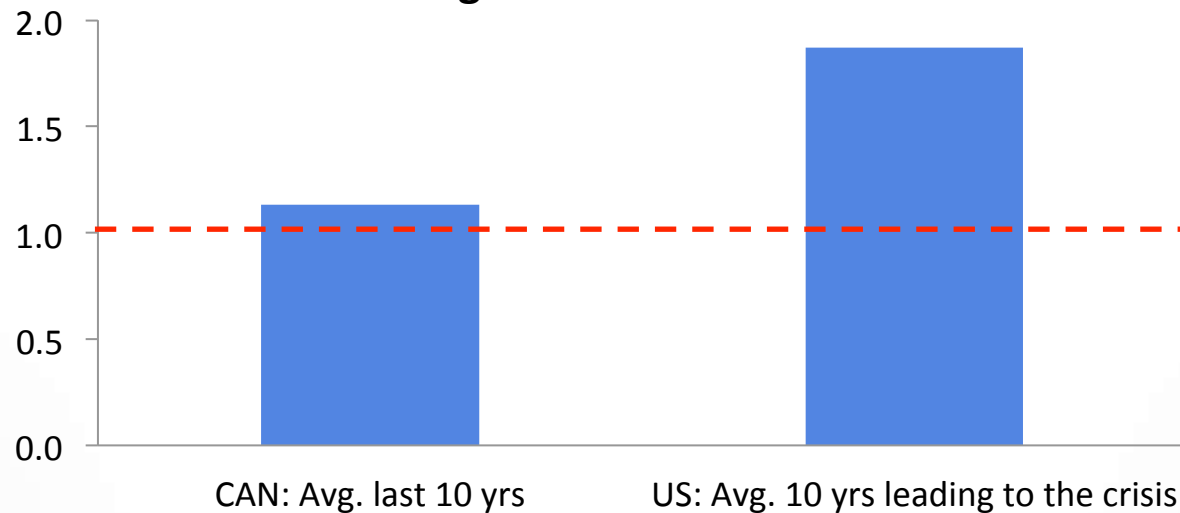
***Canadian mortgage borrowers are less susceptible to interest rate movements; pinch will be felt on consumer credit***

# RISKS & MITIGATION

## 4. Speculation is increasing “P/NAV”s

- View: Housing prices are escalating faster than birth rates, immigration rates, etc.
  - Ergo, speculation and large capital inflows from foreign investors are driving up home prices
- However, we are seeing housing starts in line with household formation

**Ratio of Housing Starts to Household Formation**

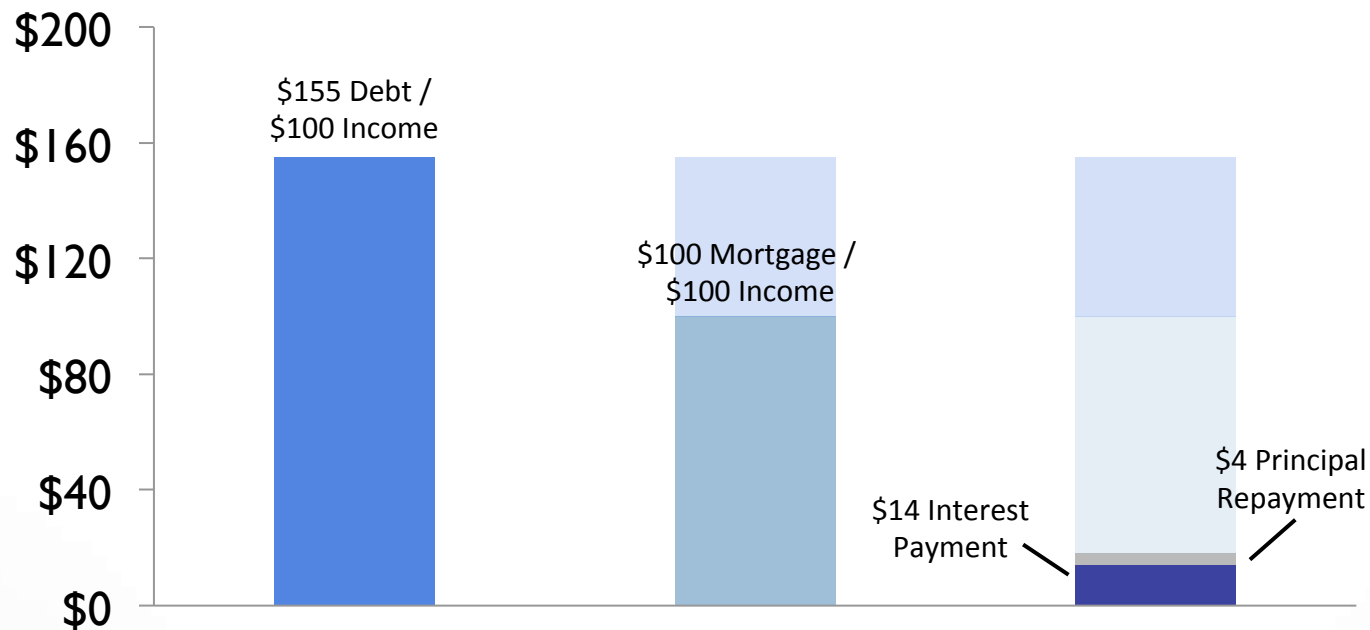


Source: Statcan



# RISKS & MITIGATION

One last argument. Let's do the math.



*Do you believe that Canadian consumers are going to default on that \$18/year payment?*

# RISKS & MITIGATION

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## Despite our analysis, there are still risks that we cannot avoid

- 1) A sharp readjustment in Canadian income levels brought on by an external shock (i.e. US Fiscal Cliff, EU Sovereign Debt Crisis)
- 2) A sharp readjustment in Canadian housing prices that would wipe out the homeowner equity of 20% of the outstanding borrowers
- 3) A third increase in CMHC's mortgage insurance cap above \$600Bn

These risks may still trouble you while making your decision about this investment...

***There are always risks we can't avoid***



Genworth MI Canada

# RISKS & MITIGATION

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...but we still have a saving grace

## Investing WITH Regulation

- The world in which we are now investing has changed drastically, especially in the realm of Financial Institutions
- New regulations including Basel III and Dodd-Frank restrict the amount of risk Financial Institutions can take on to increase returns to shareholders
- While many investors look for tiny loopholes to find “pockets” on double-digit return, let us invest in companies that have embraced this change and are strategically poised to grow alongside it
- In the case of Genworth, we have the opportunity to invest in a company that is capable of growing in a market that the government has a great deal of exposure to, and will therefore not let it fail

***At least the government is on our side.***



# BUSINESS MODEL

## *For the Lender*

- Regional sales teams supported by risk managers in each province
- Account managers to interact directly with lender customers
- Have approximately 250 financial institutions as their customers
- Focus on trying to approve files while still adhering to the disciplined underwriting approach

## *For the Homebuyer*

- Provide prospective homeowners with the tools they need to understand the home-buying process
- Customer website: [homeownership.ca](http://homeownership.ca), can assess financial situation, mortgage options, and resources

***“We maintain very high service standards ... we answer 97% of all calls in less than 20 seconds”***

Genworth MI Canada

# BUSINESS MODEL



*Genworth underwrites mortgage insurance in all provinces and territories across Canada.*

# THE SPECIFICS

## The Typical Homebuyer

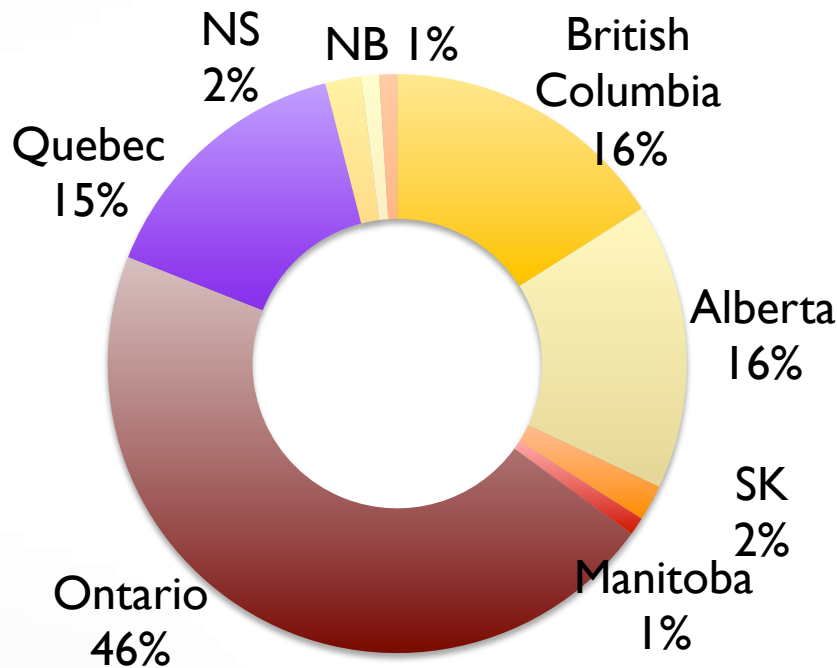
- Focuses on insuring **one to four unit properties** across Canada with a focus on **high quality prime mortgages** (i.e. Average credit score of 719) and **first-time homebuyers**



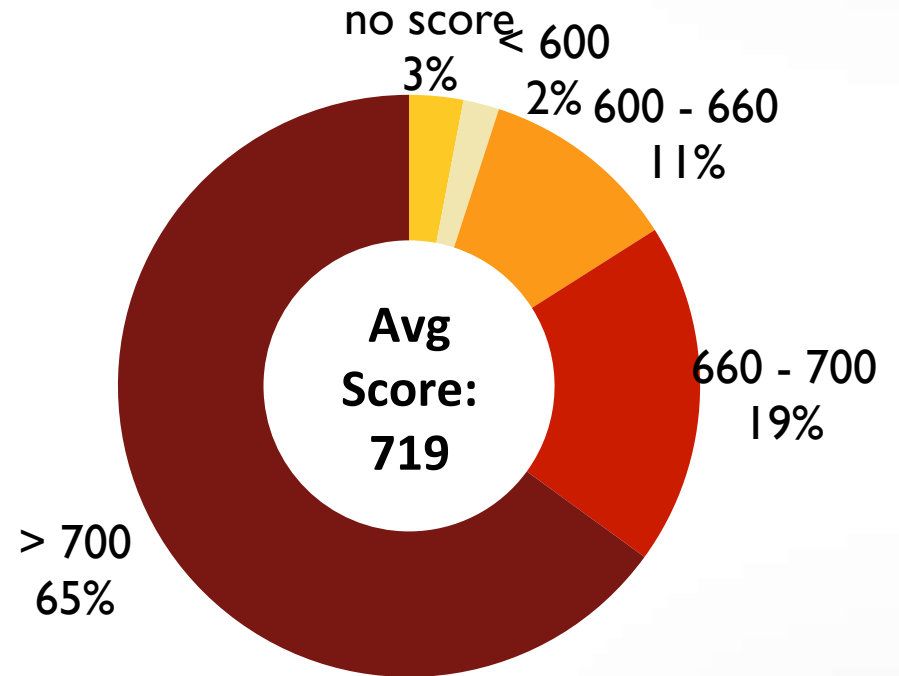
*Genworth focuses on high quality prime mortgages and its book is made up of mostly High LTV loans.*

# SEGMENTATION

**Geography**



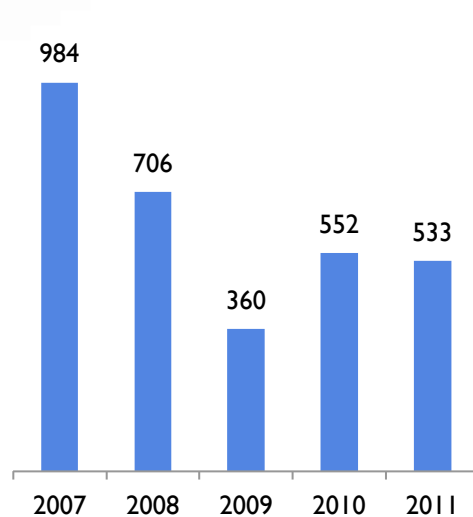
**Credit Score**



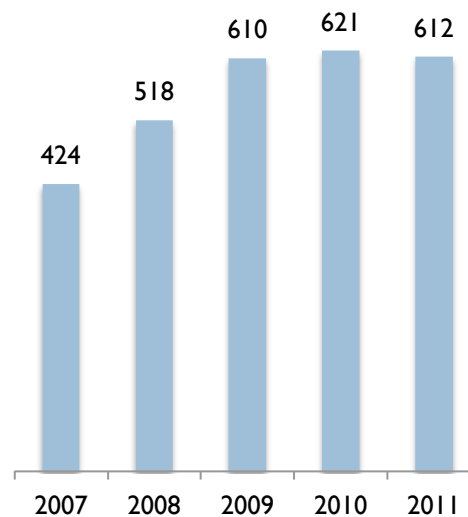
*Genworth sources most of its business from Ontario and maintains a book of high-quality loans.*

# KEY OPERATING METRICS

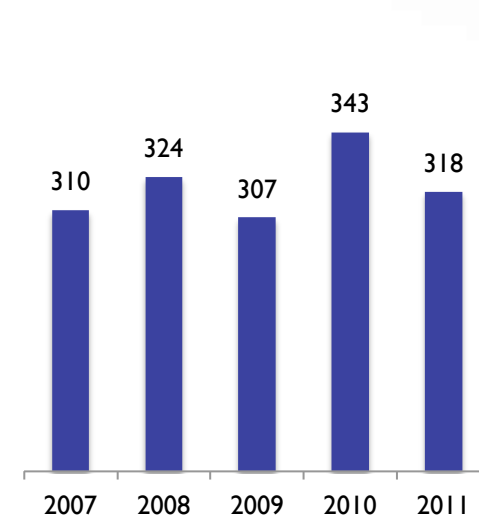
## Net Premiums Written



## Net Premiums Earned



## Net Operating Income



**Net Premiums Written:** Total premiums on insurance policies written during the time period

**Net Premiums Earned:** Premiums earned by insuring against risks during the year

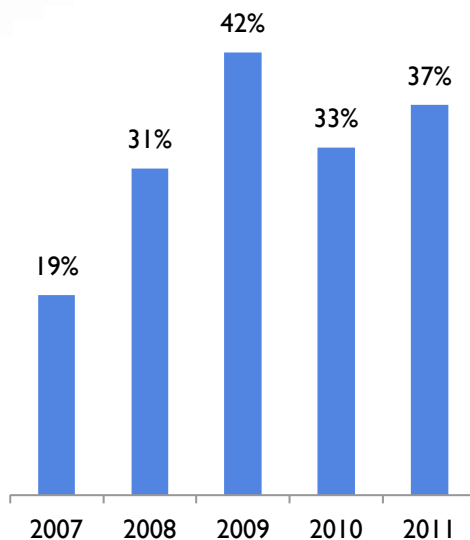
**Net Operating Income:** Net income less net gains on investments (Non-IFRS measure).

***Genworth exhibits stability in its premiums earned and net operating income over the past 5 years.***

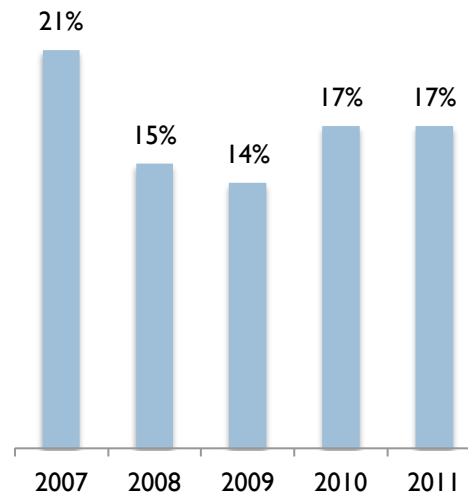


# KEY OPERATING METRICS

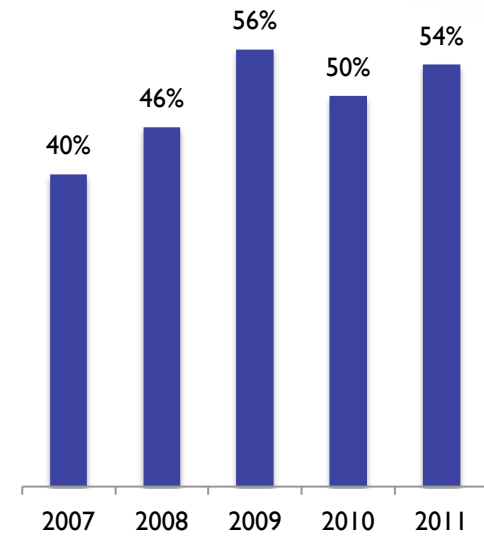
## Loss Ratio



## Expense Ratio



## Combined Ratio



**Loss Ratio:** Claims and adjustment expenses divided by premiums earned

**Expense Ratio:** All other costs in for acquiring and servicing divided by premiums earned

**Combined Ratio:** The sum of the Loss Ratio and the Expense Ratio

*Genworth's Loss Ratio saw large expansion after the financial crisis in 2007-2008 but seems to be less volatile in recent years.*

## Genworth MI Canada

# COMPARABLES

GROUP	COMPANY	MARKET CAP.	ROE	DIVIDEND YIELD	P/E	P/B
<b>CANADIAN PROPERTY AND CASUALTY</b>						
1	EGI Financial Holdings	107.48M	12.30%	0.00%	5.6x	0.7x
	Fairfax Financial Holdings	8.84B	-8.30%	2.28%	na	1.0x
	Intact	8.9B	12.60%	2.53%	17.0x	2.1x
	<b>Mean</b>		<b>5.53%</b>	<b>1.60%</b>	<b>11.3x</b>	<b>1.3x</b>
	<b>Median</b>		<b>12.30%</b>	<b>2.28%</b>	<b>11.3x</b>	<b>1.0x</b>
<b>U.S. MORTGAGE INSURERS</b>						
2	Genworth Financial Inc.	2.78 B	2.30%	0.00%	8.6x	0.2x
	Radian Inc.	0.57 B	-6.00%	0.43%	na	0.7x
	<b>Mean</b>		<b>-1.85%</b>	<b>0.22%</b>	<b>8.6x</b>	<b>0.4x</b>
	<b>Median</b>		<b>-1.85%</b>	<b>0.22%</b>	<b>8.6x</b>	<b>0.4x</b>
<b>OTHER U.S. PROPERTY AND CASUALTY</b>						
3	Hartford Financial	9.57 B	6.30%	9.65%	7.5x	0.3x
	CNA Financial	7.51 B	5.30%	1.50%	11.6x	0.7x
	Old Republic	2.67B	2.00%	7.55%	na	0.7x
	Mercury General	2.25 B	10.50%	5.35%	13.1x	1.2x
	Hanover	1.56B	7.20%	3.43%	9.9x	0.7x
	RLI Corp.	1.42B	16.22%	1.92%	13.2x	1.7x
	Selective	0.99B	5.30%	2.93%	18.9x	1.0x
	<b>Mean</b>		<b>7.55%</b>	<b>4.62%</b>	<b>12.4x</b>	<b>0.9x</b>
	<b>Median</b>		<b>6.30%</b>	<b>3.43%</b>	<b>12.4x</b>	<b>0.7x</b>
	<b>Genworth MI Canada Inc</b>	<b>2.03 B</b>	<b>12.26%</b>	<b>6.26%</b>	<b>6.5x</b>	<b>0.7x</b>

## Genworth MI Canada

# COMPARABLES

GROUP	COMPANY	MARKET CAP.	COMBINED RATIO
<b>CANADIAN PROPERTY AND CASUALTY</b>			
1	EGI Financial Holdings	107.48M	100.8%
	Fairfax Financial Holdings	8.84B	97.5%
	Intact	8.9B	94.4%
	<b>Mean</b>		<b>97.57%</b>
	<b>Median</b>		<b>97.50%</b>
<b>U.S. MORTGAGE INSURERS</b>			
2	Genworth Financial Inc.	2.78 B	77.0%
	Radian Inc.	0.57 B	214.5%
	<b>Mean</b>		<b>145.75%</b>
	<b>Median</b>		<b>145.75%</b>
<b>OTHER U.S. PROPERTY AND CASUALTY</b>			
3	Hartford Financial	9.57 B	97.2%
	CNA Financial	7.51 B	98.4%
	Old Republic	2.67B	na
	Mercury General	2.25 B	100.1%
	Hanover	1.56B	96.8%
	RLI Corp.	1.42B	78.4%
	Selective	0.99B	106.7%
	<b>Mean</b>		<b>96.27%</b>
	<b>Median</b>		<b>97.80%</b>
	<b>Genworth MI Canada Inc</b>	<b>2.03 B</b>	<b>54.0%</b>

## Genworth MI Canada

# DIVIDEND DISCOUNT MODEL

CAPM	
RFR	2.36%
Beta	0.801
MRP	5.00%
<b>Cost of Equity</b>	<b>6.37%</b>

Inputs	
Net Debt	\$349,701
Tax Rate	25%
Terminal Growth	2%
Cost of Equity	6.37%
Target Payout Ratio	45%
Total Shares Outstanding	102,004

DIVIDEND DISCOUNT MODEL					
	<u>2012</u>	<u>2013</u>	<u>2014</u>	<u>2015</u>	<u>2016</u>
Year	1	2	3	4	5
Earnings	\$277,531	\$298,269	\$305,571	\$338,271	\$355,208
Payout Ratio	45%	45%	45%	45%	45%
<b>Implied Dividend</b>	<b>\$124,889</b>	<b>\$134,221</b>	<b>\$137,507</b>	<b>\$152,222</b>	<b>\$159,844</b>
<b>Terminal Value</b>					<b>\$3,735,180</b>
<b>PV Free Cash Flow</b>	<b>\$117,415</b>	<b>\$118,638</b>	<b>\$114,269</b>	<b>\$118,928</b>	<b>\$2,860,990</b>
<b>Total Equity Value</b>	<b>\$3,330,240</b>				
Total Shares Outstanding	102,004				
<b>Implied Share Price</b>	<b>\$32.65</b>				
Current Share Price	\$20.59				
<b>Implied Upside</b>	<b>59%</b>				

# DDM - SENSITIVITIES

## Terminal Growth

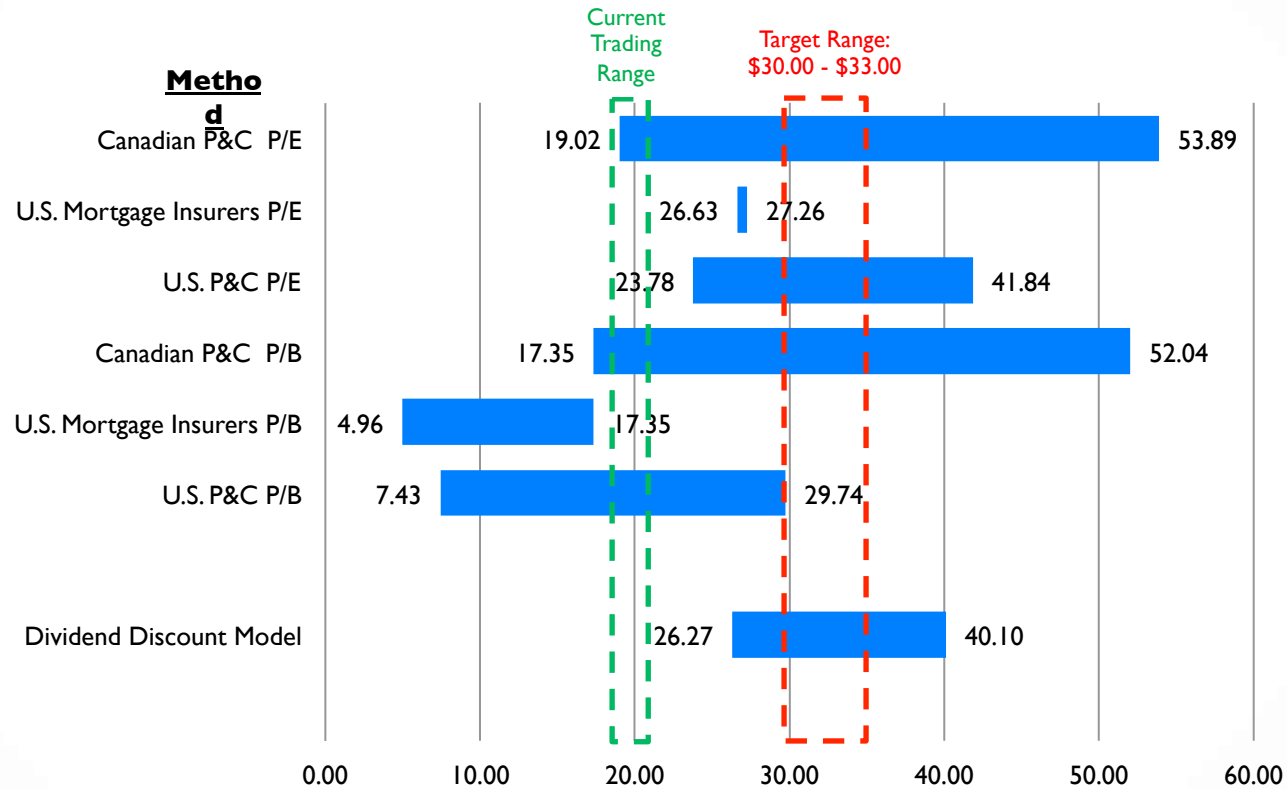
Cost of Equity	Terminal Growth				
	1.0%	1.5%	2.0%	2.5%	3.0%
5.5%	32.81	36.32	36.32	46.86	55.29
6.0%	29.46	<b>32.22</b>	<b>32.22</b>	<b>40.10</b>	46.01
6.5%	26.73	<b>28.95</b>	<b>28.95</b>	<b>35.04</b>	39.39
7.0%	24.46	<b>26.27</b>	<b>26.27</b>	<b>31.10</b>	34.42
7.5%	22.53	24.04	24.04	27.95	30.56

## Cost of Equity

Payout Ratio	Cost of Equity				
	5.5%	6.0%	6.5%	7.0%	7.5%
35.0%	31.76	27.74	24.62	22.12	20.08
40.0%	36.30	<b>31.71</b>	<b>28.14</b>	<b>25.28</b>	22.95
45.0%	40.84	<b>35.67</b>	<b>31.65</b>	<b>28.44</b>	25.81
50.0%	45.37	<b>39.63</b>	<b>35.17</b>	<b>31.60</b>	28.68
55.0%	49.91	43.60	38.69	34.76	31.55

## Genworth Financial Canada

# VALUATION SUMMARY



***Genworth is trading close to U.S. P&C peers. We feel it is being unfairly valued and should be trading closer to Canadian P&C.***

Genworth Financial Canada

# CONCLUSION

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**Buy 150 Shares of Genworth MI  
Canada (MIC) at \$20.70**



**Genworth**  
Financial  
Canada





WESTERN INVESTMENT CLUB