The ladder of complexity – Genworth and family

GNW US Equity
MIC CN Equity
GMA AU Equity

A look at a risk-reward spectrum from deep value turnaround to dividend champion oligopolies

Roshan F Padamadan
Fund Manager, Luminance Global Fund

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“In the insurance business, there is no statute of limitation on stupidity."

Executive summary

- Genworth is a unique insurance company as it does all 3 types of insurance: life, medical and property
- It has operations in US, Canada, Australia and 4 countries in Europe.
- Mortgage divisions of Canada and Australia are separately listed. Both have oligopolistic positions.
- Parent trades at ~~20%~~ 11% of adjusted book, while mortgage insurance subsidiaries trade at ~~0.8-0.9x~~ 0.7x book *
- A spin-off or split may achieve re-rating
- A year's earnings may give adequate buffer to move ahead

* Data as of 09 January 2016

Ski slope

- Insurance is tough when your numbers are wrong.
- At the core of the troubles, long-term care (LTC) insurance product was mispriced in the 1980s and 1990s. The bill came when reserves were reevaluated, last in 2014.
- Product is sold at a loss, with claims exceeding premia collected (not unusual in insurance), with dependence on investment income.
- Lapses are also important: company keeps premia paid till date. Actual lapse rate <1% vs. 5%+ for life insurance.
- LTC product is undergoing changes constantly, with rate increases and benefits reductions. Many have exited market.

Insurance key ratios

- Loss ratio: what you expect to lose due to the risk you have accepted
- Expense ratio: your cost of running the business (salaries, rent, travel, etc..)
- Combined ratio: add the loss ratio and expense ratio. Ideally should be below 100%. Insurance industry can survive with combined ratios over 100% too, as timing of claim can be quite different from premium paying period, allowing investment income from the premia collected (float) to be earned and kept. Such income may or may not be shared with policyholder, depending on policy.

Special features (LTC)

- Guaranteed renewable: Insurer cannot decline a renewal.
- Premiums cannot be increased for a particular holder – only for an entire class of policyholders. This is being done in negotiation with each US state's insurance regulator.
- Way forward is to negotiate for modest increases (single digits) each year instead of large, lumpy increases (such as 40-100%) every few years.

LTC market

- Currently 13mn people are on some form of LTC
- About 40% are between 18-64 years
  - US Government Accounting Office
- Genworth has 1.2mn LTC customers
- Legacy block (1974-2001) is 0.33mn (expected to come down to 0.12mn by 2024)
- Competition: Medicare pays for short stays, and accounts for 12% (Boston College research)
- Medicaid pays about 50% for those eligible
- Primary market is top 1/3rd of population, minus super wealthy who might self-insure (i.e. not buy insurance)

Scale of business

- Market positions :
  - Leader in LTC (USA)
  - Leading position (#4) in US Mortgage Insurance (MI)
  - One of many in US Life and Annuities
  - ~35% market share in Canada MI (#2)
  - 40%+ market share in Australia MI (#1)
  - Small player in UK, Germany, Finland, Italy

Australia MI

- 52% stake held by holdco
- 44% market share (other player is QBE LMI)
- 2015: CEO resigned. CFO takes over
- 2015: Westpac (14% of premium) ended partnership
- Combined ratio runs around 50% for 2015 (E)
- Underlying ROE 12%
- Better recourse than US ; upfront premium ; less subprime risk

Canada MI

- 57% stake, with 16% held by US MI division
- 50% of the market is with government agency
- ~35% market share. Other private sector player is Canada Guarantee (privately held)
- Genworth MIC is 90% guaranteed by government
- Combined ratio: below 50%
- ROE 12%+ last 6 years
- Better recourse than US ; upfront premium ; less subprime risk

Shareholder dynamics

- Independent Directors on board: 9 out of 10
- CEO Tom McInerney is only Executive on the board
- Holdco is widely held: Blackrock 8.4%, Vanguard 7.9%, Fidelity 5.9%
- Genworth Canada:
  - 15% held by Genworth MI (US Division), 42% by holdco
  - Institutions above 5% : Royce 6.9%, Fidelity 5.2%
- Genworth Australia:
  - Perpetual (9.9%) and Capital group (5.2%) are large institutional shareholders.
  - Large short interest of 17%

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Remedies

- Premium hikes are expected to add USD250-300mn by 2017 (company estimates)
  - Marginal contribution is close to 100%
  - Note: These hikes are used in reserve calculations, and thus in the capital ratios, so analyse via capital ratios or profit ratios, but not both.
- Holdco still has debt of USD 4bn+; aim is to reduce it by USD 1-2bn before commencing split of businesses.
- Exiting life (ex-LTC) business by selling it was not possible. But selling blocks has been successful. Reinsurance is another means to release capital.

Ways to express a view

- Genworth Financial (GNW US):
  - Shares trading at USD 3.1 (0.11 book)
- Genworth MI Canada (MIC CN):
  - Shares trading at CAD 24.64 (0.67 book). Div. yield: 6.45%
- Genworth MI (GMA AU):
  - Shares trading at AUD 2.69 (0.70 book). Div. yield 9.5% ex-Special
- Bonds available for both US investors and non-US institutions
  - GNW at yields of 7.7%, 9.4%, 12.0% for 2018/2020/2021. (BB+)
  - MIC CN at yields of 3.3%, 4.1% for 2020/2024

Data as of 09 January 2016

FAQ

- Will LTC continue to bleed?
  - Possibly. But the deterioration in book value is not likely to be anywhere close to a 90% loss from current adjusted book value. LTC reserves may increase if rate increases do not meet plans.
- Do rising interest rates help?
  - The asset book is mostly fixed income and rising rates will lift up investment yield, and assumptions used for future yield.
- Do rate increases increase cash, or reserves or capital?
  - Rate increases has low/zero marginal cost. It is cash generated from operations which drops to the bottomline. As net profits, it gets added to capital. Reserves are based on expected losses, and capital has to be held much in excess of reserves.

Appendix: Ratios and data

- **Genworth Financial**
- Ticker: GNW US Equity on Bloomberg
- Founded: oldest line 1871. Spin-off from GE 2004
- Head office: Richmond, Virginida
- Market cap (09-January-2016): USD 1,537 mn
- Price per share: USD 3.09
- Price to book: 0.11
- Combined ratio (TTM): 66.2%
- Shares outstanding: 497.5 million
- Free float: 99.8 %
- Short interest: 5.7%
- Days to cover: 3.7
- Dividend yield: % trailing 12 months
- Auditor: KPMG

Data is from Bloomberg (09 January 2016)

Appendix: Ratios and data

- **Genworth MI Canada**
- Ticker: MIC CN Equity on Bloomberg
- Head office: Oakville, Canada
- Market cap (09-January-2016): CAD 2,262mn (USD 1,629 at 0.71USD per CAD)
- Price per share: CAD 24.64
- Price to book: 0.67
- Combined ratio (TTM): 39.0%
- Shares outstanding: 91.8million
- Free float:42.6 %
- Short interest: 5.64%
- Days to cover: 8.8 days
- Dividend yield: 6.45% trailing 12 months
- Auditor: KPMG

Data is from Bloomberg (09 January 2016)

Appendix: Ratios and data

- **Genworth Mortgage Insurance** (this has only the Australian MI)
- Ticker: GMA AU Equity on Bloomberg
- Head office: Sydney, Australia
- Market cap (09-January-2016): AUD 1,601mn (1,102 USD mn at 0.7USD per AUD)
- Price per share: AUD 2.69
- Price to book: 0.70
- Combined ratio (TTM): 44.1%
- Shares outstanding: 595.4million
- Free float: 43.2%
- Short interest: 10.5%
- Days to cover: 17.7
- Dividend yield: 20.45% trailing 12 months (included special dividend)
- Auditor: KPMG

Data is from Bloomberg (09 January 2016)