FINANCIAL REVIEW

HD **Genworth floats along in cosy duopoly**

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Australian fund managers and retail investors are likely to be comfortable investing in the upcoming $2 **billion** float of Genworth Mortgage Insurance Australia, given it operates in a cosy duopoly with considerable pricing power.

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Genworth and QBE Mortgage Insurance have about 85 per cent of the lenders mortgage insurance market, which involves lenders, mainly the big four banks, virtually forcing borrowers to take out insurance against losses caused by a borrower's possible default.

The fact Genworth has been able to implement premium increases in four of the past six years without loss of market share says a lot about its pricing power and QBE's willingness to stand by and enjoy the ride.

Duopolies are a feature of local business and that has often been to the advantage of investors as opposed to consumers.

Lenders mortgage insurance is one of the few financial services products that has not been disrupted by technology. It is one of the essential components of just about every mortgage written in Australia.

Some banks have tried to reduce the amount of money they push into the coffers of Genworth and QBE by using "low deposit premiums". However, it is unlikely the Australian Prudential Regulation Authority would be happy if this type of product gained widespread traction.

APRA got a scare during the global financial crisis because of doubts that arose about the ability of the foreign-owned mortgage insurers to stand by their commitments in Australia. In the end, the companies restructured themselves and the Australian businesses were allowed to flourish. It should be noted, though, that Genworth suffered a blowout in losses in 2010.

The biggest risks to investors in Genworth would be if its commercial relationships with its lender customers broke down or there was a 30 per cent collapse in Australian house prices. The business said on Tuesday it is party to formal supply and service contracts with seven of its top 10 lender customers by new insurance written and 8 of its top 10 lender customers by gross written premium for fiscal 2013.

Genworth's top three lender customers accounted for about 55 per cent of Genworth's new insurance written and 66 per cent of its gross written premium in fiscal 2013 and its largest lender customer accounted for about 34 per cent of its new insurance written and 43 per cent of its gross written premium in fiscal 2013.

Genworth's brokers, Goldman Sachs, Macquarie Capital, UBS and Commonwealth Bank of Australia, are talking up its prospects in pre-marketing research.

The company told the Securities and Exchange Commission it will lift its profit from $220.9 million to $231 million in the year to June 2014.

Chief executive Ellie Comerford, who worked at Citi for 14 years before joining the insurance industry, has a good story to sell.

The success or otherwise of the float will, as always, depend on the pricing.

The latest $75 million capital raising by Affinity Education Group has tongues wagging in the market thanks to the amount of money going to the pockets of insiders and promoters. It has signs of what former US Federal Reserve Board chairman Alan Greenspan called "irrational exuberance".

Affinity has put the case for the acquisition of 51 childcare and education centres at a cost of $80 million at an earnings multiple of 5.2 times.

The deal is going ahead even though there are significant conditions precedent. This should sound some alarm bells for investors.

The conditions precedent include: in most cases obtaining landlord consents; regulatory license transfer approvals being obtained and completion of confirmatory due diligence.

Also, the deal requires significant negotiations around management agreements and certain contracts in relation to a corporate group comprising a significant proportion of the acquisitions. ,

The cost of the offer should raise eyebrows. Of the $98 million being raised just $80 million will be used for acquisitions. About $7 million will leak out to pay for the offer and agents' fees, which are typically paid by the vendors not the acquirer.

It is not the first time Affinity has allowed abnormally high leakage of value.

At the company's listing of 89.5 million shares, 16 per cent went to the promoters and directors leaving new shareholders with 75.5 million shares. As well, out of the money that new investors subscribed in the IPO, $7.8 million went to the promoters and directors.

Investors looking for a definition of inscrutable can find one in the actions of Cheung Kong Infrastructure Holdings in the proposed APA Group takeover of Envestra.

CKI, controlled by Hong Kong billionaire Li Ka-shing, has had since July last year to say yes or no to the proposed merger, which would create an $8 billion energy haulage and transmission company.

CKI's two directors on the board of Envestra, Dominic Chan and Ivan Chan, have opposed the merger but CKI has not said how it will vote its 17.5 per cent shareholding.

The two CKI directors on the board of Envestra reckon APA ought to offer more cash and the premium for control is insufficient even though independent expert Grant Samuel found the offer fair and reasonable.

The valuation range from Grant Samuel was $1.11 to $1.32. At Tuesday's close for APA the offer is valued at about $1.26 including the dividend. Envestra shares closed at $1.165.

The scheme booklet, which will be sent to Envestra shareholders on Friday, makes it clear that if CKI does not back the offer it will fail. Nobody involved in this deal knows which way CKI will jump but there seems to be some hope that CKI will act rationally.

At this stage neither CKI or APA has taken advantage of the truth in takeover laws to elucidate their position. That means it is possible APA will raise its offer in order to get CKI over the line. There is no way Envestra shares will stay at the current elevated level if CKI says no to the deal. That would mean big losses for the hedge funds who piled into the stock in the hope of enjoying a profit from what seemed a straightforward deal.

The Productivity Commission draft report on access to justice will not please company directors who have deplored the explosion in class actions. The commission has recommended that third-party litigation funding companies, led by Bentham IMF, be required to hold financial services licences, be subject to capital adequacy requirements and be required to meet appropriate ethical and professional standards. Also, the commission says their financial conduct ought to be regulated by the Australian Securities and Investment Commission and their ethical conduct overseen by the courts.

A licensing regime backed up by capital requirements would provide some protection for clients if a litigation funder defaulted on its obligations or engaged in serious misdonduct. However, it would do nothing to dimish the number of class actions they are funding. In fact, the commission is encouraging more class actions by recommending the government lift the ban on damages-based billing, which allows the lawyer to receive an agreed percentage of the amount recovered for the client. The lawyer is not paid if the legal action is unsuccessful.

Former Mallesons competition lawyer Roger Featherston is the official replacement for Joe Dimasi at the Australian Competition and Consumer Commission.

Featherston, who is one of the elder statesmen of competition law and a recognised communications law specialist, has been beavering away inside the ACCC for some time working on competition enforcement matters. His start date will be 35 days after the federal government announcement in order to give the states and territories and opportunity to object.

Featherston's appointment is in keeping with the system used in the US where the very best of breed in law are happy to be poachers turned game keepers.

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