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On the rebound

A little noted marker on the road to normalcy was the return to profitability of the legacy private-mortgage insurance companies. It happened in 2014, a half-decade after the 2009 business cycle bottom that followed the monstrous, real-estate-inflated 2007 business cycle top. No second acts in American lives? Tell it to MGIC Investment Corp. (MTG on the New York Stock Exchange) and Radian Group Inc. (RDN, also on the Big Board), subjects of this unfolding bullish analysis.

As you know, private mortgage insurance exists to help would-be home buyers close the gap between means and ends: between the shoppers' sometimes meager savings, on the one hand, and a full-bodied, post-bubble era down payment, on the other. Where savings prove inadequate, especially for the first-time home buyer, mortgage insurance may close the deal.

Max Karl, a Milwaukee real estate lawyer, founded MGIC (and created the PMI industry) in 1957, a time when the Greatest Generation was straining to come up with the 20% down payment to buy a \$20,000 house on average income of less than \$4,500 a year. Yes, you could apply for a loan guarantee from the Federal Housing Administration or the Veterans Administration, but you had to wait and wait.

While the dollars are bigger today, the concept remains the same. The average house costs \$200,000 compared to the average income of \$52,000. Joe or Jane Millennial wants a house. The bank wants a \$40,000 down payment; they can swing \$20,000. The answer? The purchase of \$45,000 worth of mortgage insurance that caps the

bank's maximum exposure at \$135,000. The deal closes with 10% down.

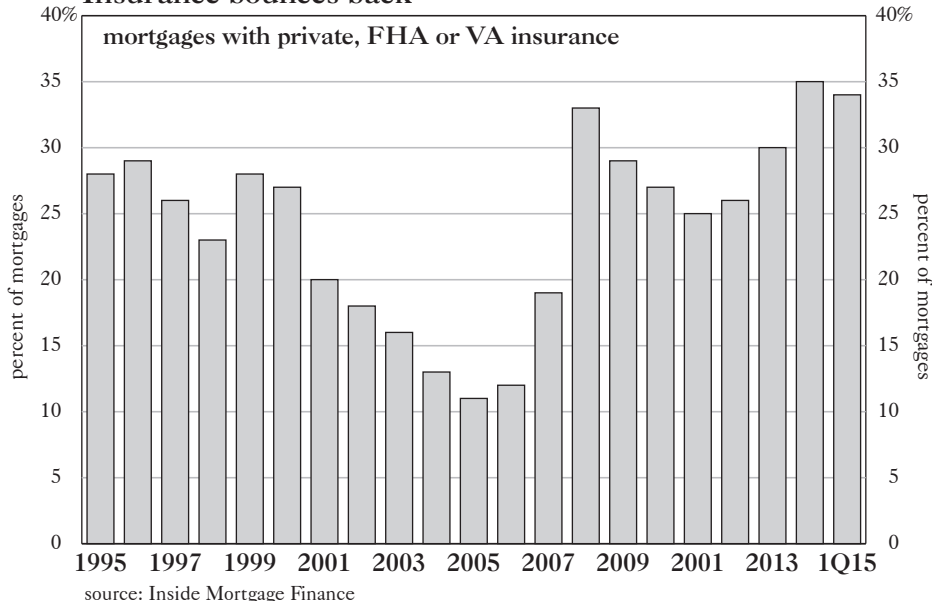
The insurance, which costs one-half of 1% of the loan balance per annum, needn't be a permanent millstone. It goes away when the homeowner pays down the loan to 78% of the home's original appraised value. The FHA's insurance product, incidentally, lacks this appealing feature. Part of the cost of the government-issued insurance policy is added to the loan. It doesn't go away until the loan does.

"Insurance in force" is one common measure of the size of a mortgage insurer; it pertains to the face value of the loans to which the insurer is exposed. "Risk in force" is another basic measure; it refers to the portion of those loans for which the insurer is actually on the hook.

MGIC and Radian are neck-and-neck in both departments: as to insurance in force, \$169 billion and \$172 billion, respectively; concerning risk in force, \$44 billion and \$43.4 billion, respectively. In each case, risk in force constitutes about a quarter of insurance in force.

The run-up to the bust was a disaster-plagued era for MTG and RDN. If you didn't have the cash for a down payment, a pliant lender would likely write you a second mortgage. Then, too, some lenders, coveting the PMI's business, formed their own captive mortgage insurance subsidiaries (which banking sideline federal regulations have subsequently all but prohibited). By 2005, MGIC, Radian et al. were insuring only 11% of mortgage originations, down from 27% in 2000.

Insurance bounces back



Not only were the PMIs not writing much new insurance, but they were also losing swaths of their existing coverage. MGIC's "persistency rate"—that is, the proportion of customers who remain on the books in a given year—ranged as low as 45% in the early 2000s, compared to an average of more than 78% in the five years to 2000.

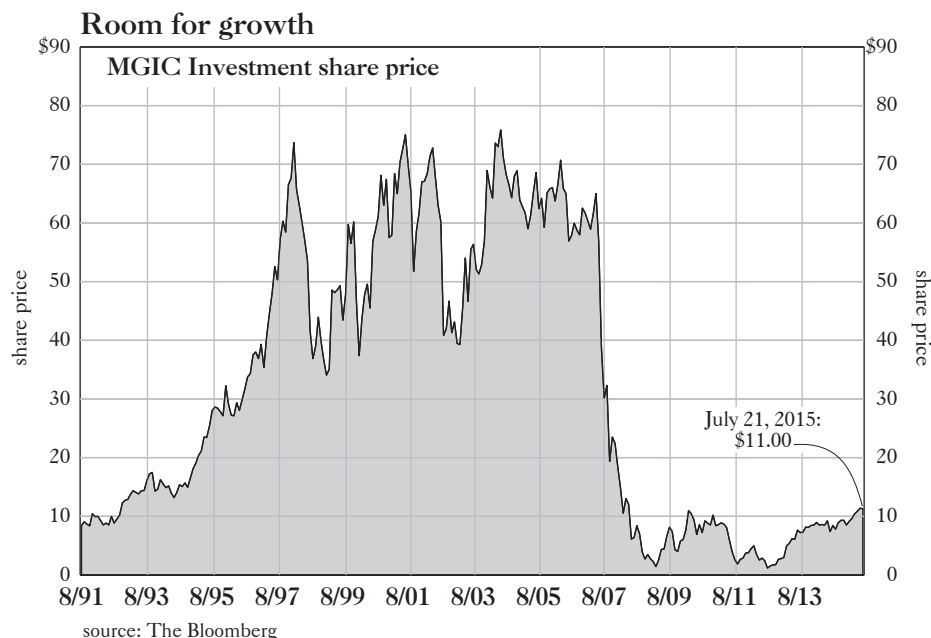
What to do? Unwisely, MGIC and Radian fell in with the spirit of the times. They teamed up to form a pair of ill-fated joint ventures, of which the more unlucky invested in subprime securities. It bit the dust.

"Three PMIs did likewise," colleague Evan Lorenz relates. "The deluge of claims drove them into run-off mode (they were PMI Group, Republic Mortgage Insurance Co. and Triad Guaranty Insurance). They were the exceptions, though. Taken as a whole, the industry paid out its claims in full and on time. The private insurers have remitted a grand total of more than \$50 billion, mainly to Fannie Mae and Freddie Mac, since 2007. MGIC alone dispensed \$15.5 billion between 2007 and 2014. New shareholders may thank their predecessors who did the suffering and the waiting; MGIC today boasts \$2.3 billion in operating loss carryforwards."

What a difference a cycle makes. MGIC and Radian are solidly profitable today. Their federal regulators stroke them. The broken bones of the mortgage market continue to knit. At last report, the percentage of mortgage loans classified as seriously delinquent stood at 3.5%, the lowest figure since January 2008, while the national foreclosure rate registered 1.3%, lowest since December 2007.

You won't hear MGIC or Radian criticizing too loudly the stricter new capital rules that the *ferderales* promulgated in April. The new regulatory regime, effective as of Dec. 31, requires a ratio of risk-in-force to capital of 14:1, rather than the long prevailing 25:1. It would seem draconian. It is, in fact, manageable. Softening the blow is relief the authorities have granted to books of business written before 2009. In consequence, the two big old-timers, MGIC and Radian, are expected easily to meet the new demand with resources on hand.

"After the financial crisis," a MGIC and Radian bull (he prefers to go nameless) tells Lorenz, "there



was a classic hard-market underwriting cycle like you see in insurance businesses over time. After the bad times, everyone raises prices, tightens underwriting. You are doing this at the same time the housing market is bottoming and turning around. After the financial crisis, you had what turned out to be multiple years of the best mortgage insurance ever written: higher return, lower loss content, written during a time when you see material home price appreciation, which helps with risk.

"You are coming out of bad times, the industry is becoming a lot more rational, and you put these good vintages on the books," our source proceeds. "From a stock perspective, that is very relevant for the legacy insurers, because the MI business is one of the longest-tailed from a credit perspective. Credit card companies went through their bust and recovery very quickly. You charge off your loan and write it all off. With mortgage insurance it takes years, especially with judicial foreclosure states. The way the accounting works, you can't take a huge up-front provision on your portfolio. Accounting mandates, you take the loss as it works its way through the system."

In the slow-motion world of mortgage insurance, bubble-era loans still accounted for 42.2% of MGIC's risk in force at the end of the second quarter. At Radian, which is expected to release second-quarter results after we go to

press, pre-2009 vintages accounted for just 29.9% of risk in force at the end of the first quarter. On the one hand, the differential speaks well of the foresight of Radian's management in building market share in the wake of the bust. On the other, MGIC's far heavier burden of doubtful business holds the reciprocal promise of greater future improvement.

How much improvement may be inferred from recent results. Thus, at MGIC, losses as a percent of premium earned—the so-called loss ratio—fell to 42.3% in the second quarter from 68% in the comparable period in 2014. Radian showed no such transformation in the first quarter: Its year-over-year comparison in loss ratio was 20.4% vs. 25%. At MGIC, legacy business produced 94% of second-quarter losses while representing only 42.2% of risk in force. "Time heals all wounds" is an adage that might have been coined with the mortgage-insurance business in mind.

MGIC and Radian are not quite two peas in a pod. MGIC is a mortgage insurer, pure and simple. Radian runs a diversified mortgage services business—loan review and due diligence, surveillance, valuations, property inspections, evictions—besides. There was an asset guaranty business, too, which Radian sold in April. MGIC employs 800 people, Radian, 1,702.

MGIC runs a famously tight ship. It spends a much lower percentage of its premium income on operating expense

than Radian does—14.7% vs. 29.6% in 2014—and has excelled in this way for years. Size and longevity tells in comparative efficiency. Essent Group, which wrote its first mortgage insurance policy in 2010, posts an expense ratio of 43.6%.

It's a funny kind of insurance business when the debt of the two leading carriers is rated junk, single-B-plus or, in the case of Radian, single-B. Such is the PMI industry.

You look at MGIC's balance sheet and everything seems to be in order. On the June 30 statement date, assets comprised, chiefly, \$4,552 million in debt securities (Treasurys, munis, investment-grade corporates) and \$216 million in cash; together, they made up 91% of total assets. Liabilities consisted of \$1.2 billion in equity, \$2.1 billion in loss reserves and \$1.3 billion in debt.

All but \$62 million of MGIC's debt takes the form of a trio of convertible bond issues: the 5s of 2017, the 2s of 2020 and the 9s of 2063. To the arbitrage community, the existence of a convertible security (i.e., convertible into the issuer's equity) is a call to action; to hedge the risk in the debt, the arbs sell short the underlying common. This fact explains why 14% of MGIC's free float has been sold short. It does not explain why the MGIC insiders this year have chosen only to sell—\$3.7 million worth of stock to satisfy tax obligations relating to share grants—and not to buy.

We expect that Radian's second-quarter financial position will look a lot

like MGICs—certainly, Radian's *first*-quarter financial position looked a lot like MGIC's second-quarter position, after adjusting for the aforementioned sale of the Radian asset-guaranty division in April. "While at first glance," Lorenz relates, "Radian has a more conservative debt-to-equity ratio than MGIC (0.55 times vs. 1.0 times, respectively), much of that difference is likely to prove temporary. Owing to sustained profits, Radian reversed a write-off of its deferred tax assets in the fourth quarter of 2014, which led to a boost in book equity. MGIC, also enjoying a run of profitability, will likely shortly do the same."

Radian, like MGIC, has issued enough convertible debt to induce a sizable arb short interest in its common stock. Have Radian's insiders been buyers of that same common? They have not been anymore than MGIC's insiders have been. Indeed, we find no net insider buying anywhere in the pure-play PMI industry.

To reiterate, we are bullish, especially on MGIC, which has the most scope for earnings improvement. It does the bullish case no harm that the government seems to regard the private mortgage insurers as a bulwark against a new visitation of credit losses on Fannie and Freddie. Not every would-be home buyer has the savings with which to materialize a 20% down payment, as Melvin L. Watt, director of the Federal Housing Finance Agency, observed in May, "but options

like private mortgage insurance enable creditworthy borrowers to get a mortgage with a lower down payment."

The likes of MGIC and Radian may be seen too as beneficiaries of any future rollback in the existing federal dominance of mortgage finance. Between 1995 and 2007, private mortgage insurance accounted for 64% of all mortgage insurance, compared to 10% for the VA and 26% for the FHA. Nowadays, private insurers claim just 36% of the insured-mortgage market, compared to 30% for the VA and 33% for the FHA. Certainly, for MGIC and Radian, there's opportunity for growth.

Talking with Lorenz, Michael J. Zimmerman, head of investor relations at MGIC, says that the company has two goals in mind with respect to capital structure: "One is to minimize dilution, and the other is to de-lever. Because, as we see the future playing out, eventually there will be a non-GSE market, and ratings will matter again. We see investment-grade on the horizon once we're compliant [with the new capital rules that will take effect at the end of the year]. Ratings agencies haven't told us this, but we believe that's the last hurdle we need to get back to an investment-grade rating. Long-term investors probably don't want just a barely investment-grade company taking the credit risk. Maybe an 'A' rating is going to be required."

Here, too, there's room to grow.

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