

Equity Research

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Financials

MGIC Investment Corporation

Near-Term Credit Improvement and Longer-Term NIW Growth in Focus Ahead of 3Q15 Report

Shares in MGIC Investment Corporation (MTG, Buy, \$12 PT) have declined by close to 16% since the company reported its 2Q15 results on July 16. Whether it contributed to that decline or not, MTG CEO Patrick Sinks during the company's conference call on that day stated that while management believed its new insurance written (NIW) would increase year-over-year during full-year 2015, it also expected the rate of increase would be less in 2H15 than it had been in 1H15.

- ▶ We believe investors should put this projected second derivative decline in MTG's NIW growth rate into perspective, as the company in 1H15 grew its NIW at a torrid 54.1% clip. Based on MTG's preliminary monthly reports, the company's NIW increased by a very healthy 19.2% during 3Q15. And while it won't impact MTG's 3Q15 results, the Mortgage Bankers Association's mortgage purchase applications index increased by 27% during the week ended October 2 to its highest level since May 2010.
- ▶ Moreover, the MTG growth story isn't really about production during the next quarter or six months, but rather about an anticipated wholesale shift in which private mortgage insurers will assume a much larger share of the U.S. mortgage insurance as the government seeks opportunities to share risk. One potential source of NIW growth that could emerge is deeper coverage of government-sponsored enterprise (GSE) mortgages – insurance that would protect investors against a larger share of losses in the case of a default. From a policy perspective, deeper front-end risk sharing on below 80% loan-to-value loans would shift risk from the GSEs (and taxpayers) to private capital. Compliance (or plans to achieve compliance) with the Private Mortgage Insurance Eligibility Requirements (PMIERs) by MTG and its peers has put them in much better position to share more of the GSEs' risk.

- ▶ **Valuation:** Our \$12 price target for MTG is based on 11.5x our 2017E earnings per share of \$1.08.

MTG

12 month target

\$9.63

\$12.00

BUY

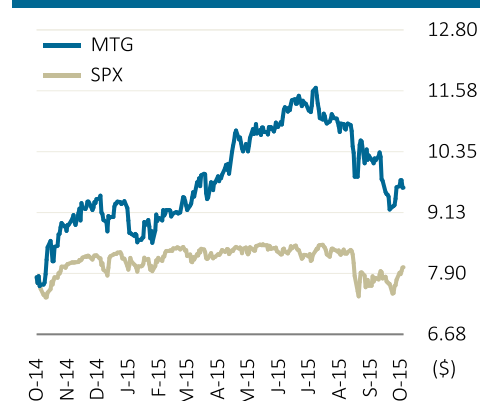
52 week range

\$7.65 - \$11.64

Market Cap (m)

\$4,229

Price Performance



Source: IDC

Estimates

	1Q14 A	2Q14 A	3Q14 A	4Q14 A	FY14 A	1Q15 A	2Q15 A	3Q15 E	4Q15 E	FY15 E	FY16 E
Net Income (Adj.)	133	114	129	137	513	94	106	111	113	425	484
Diluted EPS (Adj.)	0.15	0.11	0.17	0.17	0.61	0.32	0.28	0.29	0.31	1.15	0.96
BVPS (Ex-AOCI)	2.53	2.82	3.11	3.41	3.41	5.31	5.54	5.77	6.01	6.01	7.03

Source: BTIG Research Estimates and Company Documents (\$ in millions, except per share amount)

Please Read: Important disclosures and analyst's certification appear in Appendix

- ▶ While increases in NIW either through an expansion of the PMIs' share of the U.S. mortgage insurance pie or an increase in the size of that pie through a tailwind from the housing market represent the longer-term opportunities for MTG, in the near term the company's operating results should continue to improve as legacy portfolio run-off and new business written post-2008 under more stringent underwriting standards becomes a larger portion of its total insured exposure. While some investors examining MTG's 2Q15 report focused on management's comments on 2H15 NIW growth, we believe the primary takeaway from the report was the company's continued credit improvement driving a solid earnings beat. Delinquent inventory declined by 22.3% versus the prior year period and losses declined by 36.1% year-over-year to \$90.2mm.
- ▶ MTG is scheduled to report its 3Q15 results on Thursday before the market open with a conference call slated for 10am ET on that day. We estimate that the company will report earnings per share of \$0.29 versus the consensus estimate of \$0.22.

Among the questions we believe management should address on the conference call are the following:

- ▶ Sinks during MTG's 2Q15 conference call highlighted the opportunity for the company to provide deeper coverage mortgage insurance, and during a recent appearance at an investor conference he expressed optimism that the Federal Housing Finance Agency (FHFA) would add the item to the annual GSE scorecard before year end, setting the stage for a pilot program to be launched in 2016. **Based on management's discussions with the FHFA, what would the proposed pilot program look like? Does management have any sense of the timing of the launch of such a program based on their knowledge of the work that would need to be completed for it to occur? What is management's thinking about the potential pricing and return profile of the additional coverage?**
- ▶ After the FHFA on June 30 issued an update to the PMIERs that included an increase in the level of required assets for lender-paid mortgage insurance (LPMI) for loans with note dates of January 16 and later, MTG management during the company's 2Q15 conference call said it was reviewing the impact of the increased requirement on its returns. Approximately 17% of MTG's NIW in 2Q15 was comprised of LPMI single-premium policies. **What changes to MTG's strategy regarding LPMI singles is management contemplating?**
- ▶ Management has said that they have been analyzing their options with regard to the capital structure of MTG's holding company, adding that they are willing to consider options that add long-term value to the company's shareholders. **What is the status of this analysis, and has management reached any conclusions with regard to a course of action? What role does management see**

capital return playing in this strategy, and what is their thinking about timing along those lines?

Income Statement

MGIC - Operating Model	Dec-12	Dec-13	Dec-14	Mar-15	Jun-15	Sep-15	Dec-15	Dec-15	Mar-16	Jun-16	Sep-16	Dec-16	Dec-16	Dec-17
\$ Millions	2012A	2013A	2014A	1Q15A	2Q15A	3Q15E	4Q15E	2015E	1Q16E	2Q16E	3Q16E	4Q16E	2016E	2017E
Net premiums written	1,017.83	923.48	881.96	234.46	226.78	240.34	246.98	948.54	249.99	253.40	259.24	265.76	1,028.38	1,101.46
Increase in unearned premiums	15.34	19.57	(37.59)	(17.17)	(13.27)	(15.72)	(16.16)	(62.32)	(15.26)	(15.47)	(15.82)	(16.22)	(62.77)	(62.35)
Net premiums earned	1,033.17	943.05	844.37	217.29	213.51	224.61	230.82	886.23	234.73	237.94	243.41	249.54	965.62	1,039.11
Investment income	121.64	80.74	87.65	24.12	25.76	25.88	26.01	101.77	26.53	26.80	27.07	27.34	107.74	112.12
Realized investment gains	197.72	6.06	1.50	26.33	0.17	-	-	26.49	-	-	-	-	-	-
Total other than temporary losses	(2.31)	(0.33)	(0.14)	-	-	-	-	-	-	-	-	-	-	-
Proston of losses recognized in other comprehensive income	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Net impairment losses recognized in earnings	(2.31)	(0.33)	(0.14)	-	-	-	-	-	-	-	-	-	-	-
Other revenue	28.15	9.91	8.42	2.48	3.70	2.59	2.62	11.38	2.62	2.64	2.67	2.69	10.62	10.94
Total revenues	1,378.36	1,039.44	941.80	270.22	243.13	253.09	259.45	1,025.88	263.88	267.38	273.15	279.57	1,083.98	1,162.16
Losses incurred	2,067.25	838.73	496.08	81.79	90.24	83.83	81.74	337.59	78.64	75.18	72.26	74.08	300.16	288.65
Change in premium deficiency reserve	(61.04)	(25.32)	(24.71)	(6.42)	(17.33)	(17.16)	(16.99)	(57.90)	(6.48)	(17.51)	(17.33)	(17.16)	(58.48)	(59.06)
Amortization of deferred policy acquisition costs	7.45	10.64	7.62	-	-	2.14	2.48	4.61	-	-	2.18	2.53	4.71	4.80
Other underwriting and operating expenses	194.00	181.88	138.44	41.03	37.88	37.69	37.50	154.08	37.87	38.06	38.25	38.44	152.63	156.48
Interest expense	99.34	79.66	69.65	17.36	17.37	17.37	17.37	69.48	17.37	17.37	17.37	17.37	69.49	69.49
Total losses and expenses	2,307.01	1,085.59	687.07	133.75	128.15	123.86	122.10	507.87	127.41	113.10	112.74	115.26	468.51	460.35
Income (loss) before income taxes	(928.64)	(46.15)	254.72	136.46	114.98	129.22	137.35	518.02	136.47	154.27	160.41	164.31	615.47	701.81
Provision for income taxes	(1.57)	3.70	2.77	3.39	1.32	-	-	4.71	42.31	47.82	49.73	50.94	190.80	217.56
Net income (loss)	(927.08)	(49.85)	251.95	133.08	113.65	129.22	137.35	513.31	94.17	106.45	110.69	113.37	424.67	484.25
Diluted EPS	(\$4.59)	(\$0.16)	\$0.61	\$0.32	\$0.28	\$0.29	\$0.31	\$1.15	\$0.21	\$0.24	\$0.25	\$0.25	\$0.96	\$1.08
Diluted shares outstanding	201.89	311.75	413.55	468.14	439.15	440.25	441.35	447.22	442.45	443.56	444.66	445.78	444.11	448.57
Tax rate	0.2%	-8.0%	1.1%	2.5%	0.0%	0.0%	0.0%	0.9%	31.0%	31.0%	31.0%	31.0%	31.0%	31.0%
Book Value per diluted share	0.97	2.20	2.36	2.53	2.82	3.11	3.41	3.41	5.31	5.54	5.77	6.01	6.01	7.03
Average primary IIF	166,537.5	159,425.0	160,350.0	165,500.0	167,450.0	171,459.8	176,199.0	170,152.2	179,182.7	181,630.2	185,811.9	190,489.0	184,278.5	198,303.2
Total primary NIW	24,100.0	29,800.0	33,400.0	9,000.0	11,800.0	11,284.0	10,307.5	42,391.5	8,100.0	9,440.0	11,735.4	10,719.8	39,995.2	41,595.0
Average premium rate	0.62%	0.59%	0.53%	0.53%	0.51%	0.52%	0.52%	0.52%	0.52%	0.52%	0.52%	0.52%	0.52%	0.52%

Source: BTIG Research Estimates and Company Documents

Appendix: Analyst Certification and Other Important Disclosures

Analyst Certification

I, Mark Palmer, hereby certify that the views about the companies and securities discussed in this report are accurately expressed and that I have not received and will not receive direct or indirect compensation in exchange for expressing specific recommendations or views in this report.

I, Giuliano Bologna, hereby certify that the views about the companies and securities discussed in this report are accurately expressed and that I have not received and will not receive direct or indirect compensation in exchange for expressing specific recommendations or views in this report.

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Company Valuation and Risk Disclosures

MGIC Investment Corporation (MTG, BUY)

Valuation: Our price target of \$12 for MTG is based on 11.5X our 2017E EPS of \$1.08

Risks: The primary risks to our thesis include: Competition with other PMIs could result in lower revenues and/or lower premium yields. Additional moves by the FHA to make its mortgage insurance offering more competitive could adversely impact demand for MTG's product. A downturn in the U.S. economy could result in higher delinquencies and higher losses on MTG's existing portfolio.

Other Disclosures

Additional Information Available Upon Request

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