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Financials

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Industry Report

Private Mortgage Insurers

Given RDN's Lack of Clear Successor to Soon-to-Be Retiring CEO Ibrahim, Should ESNT Make a Bid?

Discussion among investors in shares of the U.S. private mortgage insurers (PMIs) about the potential for consolidation in the space is nothing new, but the benefits that would accrue to the industry's seven players, were they to become six (or fewer) came into sharper focus in the middle of last year when concerns about intensifying price competition arose and PMI stock prices started falling.

- We believe the potential for M&A activity in the industry may have increased after Radian Group (RDN, Buy, $22 PT) announced on Tuesday that CEO S.A. Ibrahim would retire at the end of 2017. Insofar as RDN has no clear successor for Ibrahim, who has served as the company's chief executive since May 2005, we think it would be logical to surmise that the company's board of directors may be more inclined to entertain approaches from interested suitors to a greater extent than it had previously.
- So which PMI would make the most sense as a bidder for RDN? We believe Essent Group (ESNT, Buy, $31 PT) could fit the bill for several reasons.
- First of all, ESNT's stock provides it with the acquisition currency to pursue RDN insofar as its shares trade at 1.58x the company's adjusted book value per share as of March 31, whereas RDN trades at 0.96x. ESNT is smaller than RDN, but this is far from a case of a small fish swallowing a whale: ESNT's market capitalization is $1.83bn, while RDN's is $2.56bn.
- Given the overlap in the client bases of ESNT (12.6% market share based on LTM NIW) and RDN (19.5%), the combined company likely would not have a combined market share of 32.1%, but rather one that could settle in the mid-20% ballpark, in our view. However, a deal would take out a competitor and reduce the number of players in the PMI space, which could help to mitigate persistent pricing pressure.
- In addition to providing the benefits from enhanced scale, market presence and economies of size, an ESNT-RDN combination would provide significant opportunities for expense savings.

- While it seems like ancient history at this point, RDN and MGIC Investment Corporation (MTG, Buy, $12 PT) had agreed to a stock-for-stock merger in February 2007 before upheaval in the U.S. housing market derailed the deal seven months later. We believe it is worth noting that the $128mm in pre-tax aggregate expense savings expected from that deal had been equal to 24% of the pro forma combined operating expense base.

- ESNT CEO Mark Casale, who appears to have lofty ambitions within the PMI space and is just 51, has RDN "DNA." He held several leadership positions with RDN from 2001-2007, most recently as president of its mortgage insurance subsidiary before he departed to assume his current role. While RDN has retained an executive search firm to consider both internal and external candidates, its ideal CEO may be just 18 miles away from its Philadelphia headquarters at ESNT's headquarters in Radnor, PA. We note that this proximity would help to minimize the disruption for employees at both firms.

- Insofar as the operating subsidiaries of both ESNT and RDN are based in Pennsylvania and both are regulated by the Pennsylvania Insurance Department, the regulatory issues associated with a combination would be less complicated.

- While one of ESNT's selling points has been a balance sheet that is free from insured legacy exposures and an investment grade credit rating, some investors have favored investing in RDN and MTG because of the enhanced profitability that has and should continue to result from the run-off of their legacy books and improved portfolio mixes. Combining ESNT with RDN would result in a company with a still strong balance sheet – RDN was recently upgraded to investment grade – that would benefit from the earnings uplift associated with the legacy book run-off.

- There are a few potentially complicating factors to an ESNT-RDN combination that would need to be considered. One of these is that RDN had approximately $1.1bn in net operating loss (NOL) carryforwards as of March 31 that are scheduled to expire during 2030 through 2032, and a net deferred tax asset of $518mm. While the deal structure could affect the treatment of the NOLs, the amount of them that would be lost is a consideration, and any lost NOL benefit would need to be more than offset by expense savings and other earnings drivers.

- Another question concerns an agreement between RDN and the Minnesota Department of Commerce in which the company would not enter into any new captive reinsurance agreements for a period of 10 years ending in June 2025. The company had entered into a similar agreement with the CFPB in 2013 that prohibited such agreements through 2023. While ESNT does not have and has never had such captive reinsurance arrangements, it does operate a Bermuda-based reinsurer, Essent Re. We believe clarity on the status of RDN's agreements with the regulators – and whether ESNT's quota share agreements would impact the regulators' views – in the event of a combination with ESNT would be helpful.

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

Essent Group Ltd. (ESNT, Buy, $31 PT)

Valuation: Our price target of $31 for ESNT is based on 12X our 17E EPS of $2.62.

Risks: Risks to our recommendation include legislative or regulatory actions or decisions to change the role of the GSEs in the U.S. housing market, actions to decrease or discontinue the use of mortgage insurance or changes in the GSEs' eligibility requirements for mortgage insurers that could reduce ESNT's revenues or adversely affect its profitability and returns; a reduced amount of insurance ESNT may be able to write if lenders and investors select alternatives to private mortgage insurance; the negative impact on revenues, profitability and returns if ESNT were to lose a significant customer; the potential adverse impact on ESNT's business prospects and operating results if the Consumer Financial Protection Bureau's final rule defining a qualified mortgage (QM) reduces the size of the origination market or creates incentives to use government-supported mortgage insurance programs; a potential increase in ESNT's losses if a downturn in the U.S. economy or a decline in the value of borrowers' homes from their value at the time their loans close results in more homeowners defaulting.

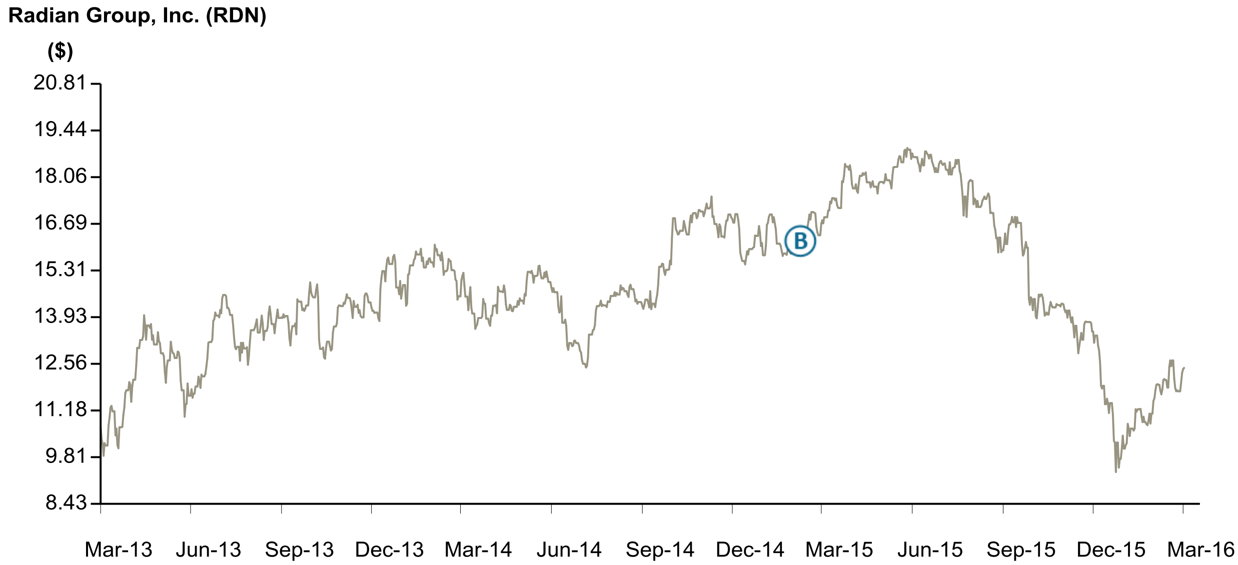
Note: Closing Price and Target Price have been adjusted for corporate actions.

Date	Closing Price ($)	Target Price ($)	Analyst	Rating
31-Oct-13	21	28	Mark Palmer	Buy
13-Feb-15	24.18	31	Mark Palmer	Buy

Radian Group, Inc. (RDN, Buy, $22 PT)

Valuation: Our price target of $22 for RDN is based on 12X our 2017E EPS of $1.80.

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



Note: Closing Price and Target Price have been adjusted for corporate actions.

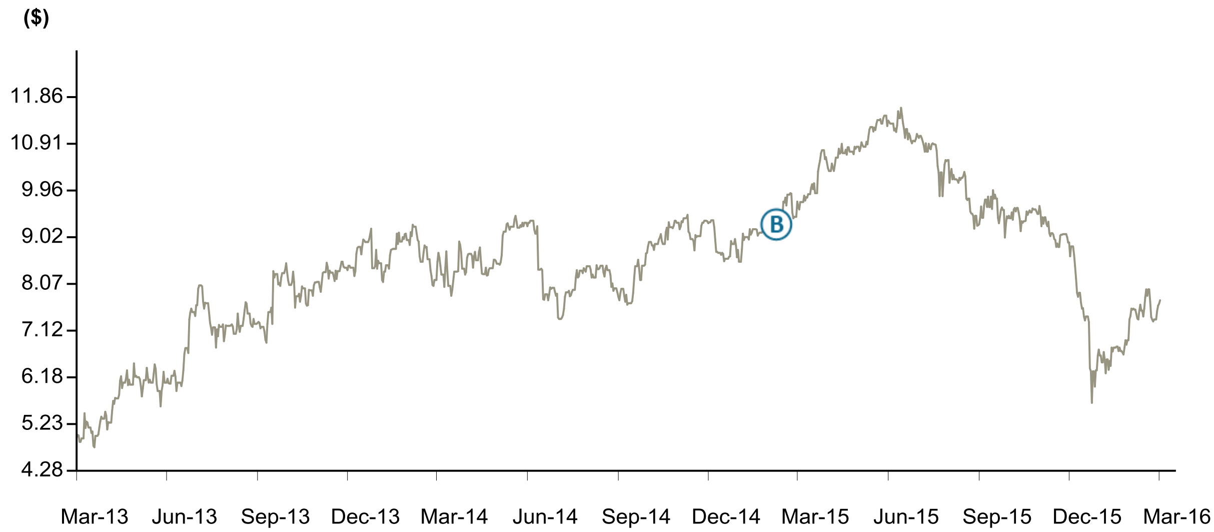
Date	Closing Price ($)	Target Price ($)	Analyst	Rating
09-Mar-15	16.17	22	Mark Palmer	Buy

MGIC Investment Corporation (MTG, Buy, $12 PT)

Valuation: Our price target of $12 for MTG is based on 11X our 2018E EPS of $1.11

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 in higher delinquencies and higher losses on MTG's existing portfolio.

MGIC Investment Corporation (MTG)



Note: Closing Price and Target Price have been adjusted for corporate actions.

Date	Closing Price ($)	Target Price ($)	Analyst	Rating
09-Mar-15	9.27	12	Mark Palmer	Buy

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Additional Information Available Upon Request

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