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Radian Group, Inc. (RDN)

Bank of America Merrill Lynch Leveraged Finance Conference

CORPORATE PARTICIPANTS

J. Franklin Hall
Chief Financial Officer & Executive Vice President, Radian Group, Inc.

MANAGEMENT DISCUSSION SECTION

[Abrupt Start]

Unverified Participant

...and I'm the Insurance Analyst at Bank of America. I would like to take this opportunity to thank you for attending our Leveraged Finance Conference and to the Radian team for joining this conference panel. Up next this morning we have Radian Group, which is a $3.1 billion market-capitalized, leading private mortgage insurer that is based in Philadelphia.

Radian operates in two business segments. Its first division, Mortgage Insurance, provides insurance coverage to residential mortgage lenders mainly through its subsidiary, Radian Guaranty. The second division, Services, provides data analytics and consulting services for buyers, sellers and investors of mortgage and real estate debt, mainly through its primary subsidiary, Clayton. At the end of the third quarter, Radian had about $181 billion of primary insurance in force.

With us today, we have our main speaker, the Chief Financial Officer, Frank Hall. Mr. Hall joined Radian in 2015 after serving over 15 years at First Financial Bancorp, including several executive roles, most notably as Chief Operating and Chief Financial Officer. Mr. Hall began his career with Ernst & Young and earned a bachelor's degree from my alma mater, Miami University, followed by an MBA from Xavier University.

I now welcome Mr. Hall to share his presentation on Radian and discuss the details of Radian's business with you. There will be a time for Q&A after his presentation. Thank you very much.

J. Franklin Hall

Chief Financial Officer & Executive Vice President, Radian Group, Inc.

Thank you, [ph] Andrew (01:43). And thank you, Bank of America Merrill Lynch, for hosting this event today. I am Frank Hall, Chief Financial Officer for Radian Group. Before we get started, it is important to note that some of the statements I will make today will be forward-looking. These statements, as well as Radian's prospects, are subject to certain risks and uncertainties. You should read about these risks on slide 22 of our presentation.

As you know, the mortgage insurance industry is an insurance specialty that is supported by one of the largest asset classes in the world, U.S. housing. Our presentation today is focused primarily on the U.S. housing market, our business segments and mortgage insurance and mortgage and real estate services, and our capital structure.

We believe that since the financial crisis, the underlying fundamentals of the U.S. housing markets are favorable for mortgage insurers.

Turning to slide three, from an economic perspective, unemployment is at its lowest level in seven years. Interest rates, despite a recent uptick, remain at historic lows. In fact, the average 30-year fixed-rate mortgage over the past 20 years is only 5.7%. Home prices are recovering nationwide but remain well within the affordability norms and are in line with affordability metrics, namely borrower income. From a regulatory perspective, the landscape has improved significantly since the financial crisis and regulators have made great progress by imposing limitations on what is considered a qualifying mortgage, which enhances the quality of the underlying loan.

Regulatory changes have also enhanced loan servicing standards, which now emphasize keeping people in their homes and thus preventing foreclosures. As a reminder, and this is a very important point, mortgage insurance claims are only paid in the event of a foreclosure, so this is good news for mortgage insurers. This enhanced regulatory landscape has also driven much higher credit standards and much higher manufacturing quality of loans originated post crisis. CoreLogic's housing credit index, a measure of credits standards, indicates that we are currently five times tighter than credit standards in 2006.

Full documentation loans are standard. Appraisal regulations has strengthened so that there is greater independence from lenders. FICO scores, which we will detail later, have increased such, that those utilizing private mortgage insurance have an average FICO of 740 or greater. Fixed rate mortgages are the dominant product of choice for borrowers. And finally, loans with multiple risky attributes are largely a thing of the past. In summary, the landscape that helped create the financial crisis has significantly changed for the better, and our insured portfolio has benefited from this change for the past seven years.

Moving now to slide four. We have presented here the trend of mortgage originations from 1990 to a forecasted 2017. Of particular note is that the forecasted 2017 mortgage origination market is expected to have the highest level of purchased originations in the past 10 years. This expectation is further evidence of what we see in other studies and that there is still a preference of U.S. households to own their own home. What is encouraging for private mortgage ensures about this graph is that purchase originations are four times as likely to use mortgage insurance than refinance. Overall, the evidence supports a healthy U.S. housing environment and outlook and therefore, a healthy environment for mortgage insurers.

So what is private mortgage insurance? On slide five here, we've illustrated some of the high points. Prospective homebuyers who do not have a 20% down payment are viewed by lenders as a higher credit risk. However, private mortgage insurance protects the lender against a portion of first loss in the event of default, and therefore enables these borrowers to qualify for a conventional loan. Private mortgage insurance does this by meeting a requirement established by Congress that low down payment loans sold to the government-sponsored enterprises, Fannie Mae or Freddie Mac, have an extra loan level credit protection.

There are many differences between private mortgage insurance and government mortgage insurance, which is offered through the Federal Housing Administration and backed by taxpayers. But one key difference is that FHA insurance covers the entire mortgage amount as compared to private mortgage insurance, which, as you can see here on slide five, covers a portion of the original loan amount.

Another difference worth noting is that private mortgage insurance automatically cancels when the loan reaches a loan-to-value of 78%, whereas FHA insurance premiums are charged for the life of the loan. On this slide, you can also see representative pricing for each of these loan-to-value buckets. Private mortgage insurance pricing is risk-based, therefore lower loan-to-values and higher borrower FICO scores generally mean lower pricing.

Turning to slide six, this is simply another look at how private mortgage insurance helps prospective homebuyers to overcome the largest barrier to home ownership: the down payment. This is a particularly interesting point in light of the expected changes in the political landscape. At Radian, we believe that private mortgage insurance is well received by both sides of the political aisle and that we are a source of private capital ensuring potential losses, not leaving that risk to the tax payer and that we help broaden the opportunity for home ownership by supporting low down payment mortgages.

Radian is headquartered in Philadelphia and provides private mortgage insurance, risk management products and real estate services to financial institutions through two business segments. Our mortgage insurance segment accounts for approximately 85% of our revenues and is a capital-based business. Our services segment represents approximately 15% of our revenue and is a fee-based with no regulatory capital requirements for operations.

Some financial highlights for Radian Group are presented here on slide eight. Several numbers to note are our increasing book value per share currently at $13.47 as of September 30, and the positive trend in our total assets and stockholders' equity. Also noted here is our long-term debt which I will speak to in greater detail shortly.

Radian is well-positioned to provide long-term profitability and stability. Radian maintains a portfolio of risk that has been originated through some of the best credit years in history. As I mentioned earlier, the post-crisis mortgage lending environment has been outstanding. We continue to add to that portfolio each day, while the limited pre-crisis legacy book continues to shrink.

Radian is among the few companies in our industry to have successfully navigated the financial crisis and we continue to command a sizable position and strong reputation among lenders as a leader. This leadership position helped us to write a large volume of high-quality, profitable new business after 2008, which has improved the quality and composition of our total mortgage insurance portfolio.

Less than 15% of our total insurance in force is from origination years prior to 2009. Our customer base and geographic business mix are diverse. We work with lenders large and small, as well as bank and non-bank originators. This diversification further adds to the favorable risk characteristics of our portfolio. The regulatory capital landscape has been improved by the Private Mortgage Insurer Eligibility Requirements or PMIERs established by the GSEs, Fannie Mae and Freddie Mac, that established uniformity in the industry.

This uniformity provides capital standards and consistency among private mortgage insurers from which pricing and risk management decisions are made. It has also effectively decreased the risk to capital to levels below the maximum state regulatory levels. For instance, Radian is now effectively writing new business under PMIERs at a risk to capital level below 14:1, while the state maximum level remains at 25:1.

And finally, the improved capital structure and cash flow of Radian Group, which I will discuss further, positions us to return capital to stockholders as you can see from our first quarter $100 million share repurchase activity and through our Board's authorization for an additional $125 million share repurchase program. This strong capital position is also the underpinning for our efforts to return to investment grade at the holding company. Currently, Radian Group is rated Ba3 by Moody's and BB by S&P, and we have had multiple upgrades in the past two years.

Turning to the fundamentals of our business, slide 10 provides a snapshot of our mortgage insurance portfolio composition today versus in 2007 before the housing downturn. These comparisons are important to understand given that the composition of our risk in force reflects the environment in which the loan was underwritten.

In general, loans written before 2009 reflect the significantly weaker credit environment and underwriting standards of that time, as well as a much more lenient regulatory environment. In contrast, loans written after the downturn in 2009 and later reflect a tight credit environment and the more stringent underwriting and regulatory requirements I referenced earlier.

In addition to improved overall credit characteristics for today's business, layered risk or the combination of risky attributes in one loan, declined significantly beginning in 2009. This risk layering contributed to the losses we experienced after the housing downturn and also made the adequate pricing of loans risk extremely difficult.

The regulations in place since 2009 create an underwriting environment where this type of risk layering is much less likely to be repeated. Some of these historical practices included cash-out refinancing, no documentation loans, et cetera. When we consider the risk involved in any given loan, in addition to credit quality, we pay close attention to the underwriting or manufacturing quality of the loan.

One way to measure that underwriting quality is through early default experience as you can see here on slide 11. What this chart illustrates are the 6- and 12-month rates of default following origination. Most importantly, you can see that the rates of default in this early stage are extremely low beginning in 2009. You can also see here that today's low rate of early default is not only significantly below where we were just after the downturn in 2008 and 2009, but it is also significantly below where we were in the early 2000s.

Another important indicator of loan manufacturing quality is our own quality control. Post crisis our industry has significantly increased the size and the scale of our quality control efforts. And this is translating into extremely low material underwriting defect rates. So again, strong credit and underwriting quality across the board.

In further support of the positive fundamentals at Radian, we continue to see an improvement in cure activity. A cure, for those unfamiliar with our industry, represents a loan that was in default at the beginning of a period that is no longer in default at the end of the same period based on payments received. In fact, cure improvements this year on our oldest delinquent loans were the highest they had been in more than seven years.

Turning now to slide 13, we have illustrated by origination of vintage year the premiums earned, the incurred losses and the net of those two numbers both on a year-to-date 2016 basis and a most recent quarter basis. What is most important to note is that our high quality books of business post crisis are generating strong premium for our company. Another interesting point is that even our legacy books of business written before 2009 are collectively contributing positively to earnings.

Turning now to slide 14. The detail here depicts the culmination of strong credit and underwriting quality, producing very low cumulative incurred loss ratios for our post-2008 portfolio. Many of these books are turning out to be the best we have ever written in our nearly 40-year history. In fact, we see some of these vintages that have already passed their peak default years, and are settling into the upper single digits with extraordinarily low loss ratios for the book.

It is also important to note that for our pricing and profitability projections, we assume a through-the-cycle loss ratio of approximately 20%, a higher loss ratio, of course, than many of these books are exhibiting today. This simply means that while we estimate at origination that our returns on new business will generate mid-teen returns on required capital, lower actual losses will enhance those actual returns.

Slide 15 provides highlights of the PMIERs, the Private Mortgage Insurer Eligibility Requirements, which are the counterparty requirements imposed on mortgage insurance companies by the GSEs. The PMIERs, which went into effect at the beginning of this year, provide a robust risk-based capital framework that is applied at the loan level, which requires mortgage insurers to withstand a significant stress scenario. And given the increased capital requirements under the PMIERs, mortgage insurers would be significantly stronger counterparties going forward as all will be required to maintain adequate liquidity and claims-paying resources to withstand a significant stress scenario. As a result, we feel the PMIERs also provide a level capital playing field and standards that ensure industry risk and price discipline, which was not the case prior to the downturn.

Radian guarantees PMIERs' available asset cushion is approximately 7% of minimum required assets consistent with our expectations. Keep in mind that in addition to the cushion at the operating company, there is also accessible capital at the parent company that currently represents another 6% of minimum required assets after our expected future capital actions based on our projections and the current requirements under the PMIERs. It is also expected that Radian Guaranty will continue to build available assets organically over time.

Turning to our Mortgage and Real Estate Services segment, slide 16 helps illustrate how the Clayton family of companies within the segment broadens our participation in the residential mortgage market value chain. The products and services we offer through these companies range from those needed at origination, including automated valuation models, title and closing services to post-closing loan reviews and servicing audits.

In addition to the value these companies provide to their existing customers, we are able to differentiate ourselves among our mortgage insurance competitors through the unparalleled breadth and depth of our mortgage risk management solutions. Introducing our large and growing customer base to these additional product offerings helps to deepen our mortgage insurance customer relationships and also expand our business.

In addition to the customer benefits generated by our services segment, there is also internal benefit from our combination. We are uniquely positioned to closely monitor quality and performance trends across our companies, and therefore identify mortgage market risks earlier than many of our peers. This information helps inform our risk management teams and help support better risk mitigation.

On slide 18, we have highlighted several key components of our strong capital and liquidity position. As of the third quarter end, we had approximately $483 million of parent company liquidity. We have largely completed the capital plan that we outlined late last year where we sought to improve our capital structure by removing the convertible notes and distributing our debt maturities more evenly. And we just announced the redemption of our 2019 convertible notes. We completed several capital activities in the third quarter, and the combination of all of our 2016 capital actions decreased the company's total number of diluted shares at September 30 by 23.1 million shares. And Radian's debt-to-capital ratio is now well below our targeted 30% at approximately 27%.

We continue to move forward on our path to returning to investment grade at the holding company. In September, we received a ratings upgrade for both Radian Group and Radian Guaranty, putting us one step closer to our goal for Radian Group. Radian Guaranty continues to be an investment grade rated company by both Moody's and S&P. We have also noted another positive for Radian that supports our holding company cash management and that we have an operating expense and interest expense reimbursement arrangement with our operating subsidiaries. This gives us the comfort and confidence that the bulk of holding company operating and interest expense is being supported by the positive cash flow and strong operating performance of the mortgage insurance subsidiary.

Illustrated here on slide 19 is a historical view of our statutory capital and the risk to capital ratio. I have illustrated this information for two reasons. First, to contrast the significant change since only 2011 and to provide a comparison of a state regulatory view versus a PMIERs view. PMIERs is the binding capital framework from which our operating company must comply in order to continue writing mortgage insurance for GSE-eligible loans. These guidelines became effective on December 31, 2015, and are determined by the GSEs. What is most noteworthy is the PMIERs requirements have significantly strengthened the capital for the private mortgage insurance industry. As we at Radian contemplate future capital actions, the relative landscape from a state regulatory perspective is much better today than it's expected to be in the future.

On slide 20, we have illustrated our overall consolidated capital structure as of September 30, 2016. One key item of note is that our total debt leverage after redemption of the 2017 senior notes is now below 30%, a key milestone for us in our quest to return to investment grade at the holding company. We have also just announced the redemption of our 2019 convertible notes, which takes our debt leverage down even further. Our investment portfolio has a conservative allocation of highly rated assets as you can see illustrated here on slide 21. The portfolio has average duration of approximately five years with a weighted average yield of approximately 2.7%.

And in closing, Radian remains very well positioned to further benefit from a strong housing market, a strong credit market and continual improvements in both new business volume and operational efficiencies. Our differentiated approach to relationships bolstered by our Clayton companies gives us an unparalleled advantage over other private mortgage insurers. Our balance sheet is strong and getting stronger, and our earnings power continues to be solid.

With that, [ph] Andrew (24:22)?

Unverified Participant

I'd like to turn it to the audience to see if there's any questions at the moment.

QUESTION AND ANSWER SECTION

Q

[indiscernible] (24:33-24:37) pretty well right now as a BB credit, like, can you articulate why it's important for you to get investment grade? And what are the specific metrics the agencies are looking for to upgrade you?

J. Franklin Hall

Chief Financial Officer & Executive Vice President, Radian Group, Inc.

A

Sure. So the importance for us to return to investment grade is really from a strategic vantage point. Obviously, that would help potentially reduce the overall cost of capital on a go-forward basis with higher ratings. And also, we think that there are some business opportunities that may be more available to us with an investment grade rating more so than sub-investment grade. But both strategic and financial reasons are really the motivation to return to investment grade.

As far as specific metrics, other than just general guidelines around being below 30% debt to total capitalization, maintaining sufficient parent company liquidity to deal with any single-year debt maturities, smoothing out the maturity profile of the organization. Those are just generally the guidelines and the counsel that we've received from the rating agencies. As far as specific metrics, those aren't readily available.

Q

Piggybacking off of the gentleman's question, do you have a specific debt-to-cap ratio target that you desire at holdco? And maybe you can speak a little bit about holdco liquidity on a go-forward basis.

J. Franklin Hall

Chief Financial Officer & Executive Vice President, Radian Group, Inc.

A

Sure. So as I mentioned, we have sufficient holding company liquidity, roughly $483 million, at the present time. After we take care of the converts and allow for some other items, we expect that number to be slightly under the $300 million. And we've targeted and said publicly between $300 million and $350 million of parent company liquidity. As far as a target debt to cap, below 30% is generally what we've said where we feel we need to be to achieve that investment grade rating. If that drifts organically into the mid-20%s, that probably feels about the right place.

Q

Thank you. Does anyone else have additional questions?

Q

Just looking back on slide 14. If you had additional vintages in there from 2006, 2007, 2008, what would those cumulative losses look like?

J. Franklin Hall
Chief Financial Officer & Executive Vice President, Radian Group, Inc.

A

Certainly much higher, which is why we've taken the approach when it comes to pricing to take a through-the-cycle view of roughly 20%. So obviously, we've got much lower levels than that 20%. And in those previous years, those numbers would be much higher.

Q

What are they, 30% or 40%? Do you have any sense?

A

Yeah. On average [indiscernible] (27:29).

J. Franklin Hall
Chief Financial Officer & Executive Vice President, Radian Group, Inc.

A

Yeah. I would say on average for those years (sic) [historical pre-crisis years] (27:33), about 35%.

Q

Thanks.

Q

Sticking to that theme, can you talk a little bit about the inventory of defaulted loans about 3.5% of insured loans, maybe some default trends and cure expectations going forward? I know in your prepared remarks you mentioned cures are at their highest in seven years, maybe you can highlight what are some of the drivers behind that.

J. Franklin Hall
Chief Financial Officer & Executive Vice President, Radian Group, Inc.

A

Yes. So I think if you look at our default inventory, most of it still continues to be from the legacy book, roughly 77% of the default inventory is from the crisis era. And then as you look at even the composition of those, we see a large a number of re-defaulters. And oddly, the re-defaulter from a risk perspective is a better risk than a new default simply because we understand their behavior over time. So most of the risk and the default information that you see for us really is isolated to the legacy book.

Q

Stepping back a second, can you talk a little bit about sort of the business outlook and growth? Radian currently has about 19% of the PMI market share. Can you update us in some of the strategies you have in place to capture more market share from other PMIs and from FHA and how you plan to grow the MI business going forward?

J. Franklin Hall
Chief Financial Officer & Executive Vice President, Radian Group, Inc.

A

Sure. So there are a few things that I would point to that make us optimistic about growth prospects. One of them is when you look at the concentration of mortgage originations in the largest lender in the space, we are not yet adequately represented in that distribution among those largest originators. So there are still opportunities for us to penetrate deeper into the allocations of the largest lenders, which is one key point.

The other is when we look at things like the elevation that the FHFA just announced as far as loan limits, increasing from $417 million to $424 million, we think that certainly helps. And then when you look at the risk profile of what the FHA is currently producing and roughly 18% of what the FHA has as far as mortgage insurance that they've covered and written recently is 720 and above FICO. And if you think about where private mortgage insurance is more suitable versus where the FHA is more suitable, arguably that 18% should be allocated to private mortgage insurers and not the FHA.

So those are just some general areas that I would say. And then the other areas, and I mentioned it in the presentation, one of the things that's unique about Radian is our mortgage and real estate services. And when you think about the origination tools and products and services that we have to offer, there really is no other private mortgage insurer that has those as well. So we have title brokerage capabilities, we have valuation, broker price opinion-type capabilities, origination services, again, that others don't have. So we expect that to play well in many of our midsized and smaller originators.

Q

[indiscernible] (31:00-31:04)

J. Franklin Hall
Chief Financial Officer & Executive Vice President, Radian Group, Inc.

A

Very good point. I was just reminded of a recent transaction that is expected to free up some market share, the AIG transaction in particular, and they have publicly stated that they expect to give up some market share in that combination so we would expect to receive our fair share of that as well.

Q

Maybe stepping back one more step, a more of a macro question. President-elect Trump in his campaign, he didn't speak much about the mortgage or the housing sector, though comments since his election have indicated some potential policies. Do you have any updated thoughts on President-elect Trump's policies, how it impacts the PMI industry and specifically GSE and potentially housing reform?

J. Franklin Hall
Chief Financial Officer & Executive Vice President, Radian Group, Inc.

A

Yeah. I think it's certainly too soon to speculate on any of those items but I would say, again, as I said in my prepared remarks, private mortgage insurance plays well on both sides of the aisle in Washington, which is good. We are private capital. If anyone does the study of history, you'll see that we stayed in the fight, if you will, throughout the crisis. We continue to pay claims and that private capital was important throughout the crisis.

So I think that if you look at lessons learned, you'll see that we were a successful component of dealing with the crisis. Other attributes and things that have been speculated about, I see them as potentially helpful to private mortgage insurers, but I think there is one important point as people are forming macro views around housing, what the regulatory environment looks like for housing, et cetera, and that is that the private mortgage – the privately insured portion of the mortgage origination market is only about 13%.

So I think that's always important to keep in mind and keep in context as you assess what macro trends are. The point that I like to frequently make is that when you look at headlines around housing prices and bubbles in places like San Francisco and New York and other places like that, that's not the market where you see private mortgage insurance. So you need to take some of those headlines with a grain of salt as it relates to evaluating a private mortgage insurance company.

Q

Does anyone have any final questions?

Unverified Participant

Well, time is up. Thank you very much for coming and presenting to the conference today.

J. Franklin Hall

Chief Financial Officer & Executive Vice President, Radian Group, Inc.

Thank you very much.