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RDN - Radian Group Inc at Goldman Sachs Leveraged Financial Conference

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PRESENTATION

Lara Devieux - *Goldman Sachs - Analyst*

Okay, we're going to get started. Hello, my name is Lara Devieux, and I'm the insurance credit analyst at Goldman Sachs. We are very happy to have mortgage insurance company, Radian, here at our conference. Joining us from the Company are the CFO, Frank Hall and the Corporate Controller, Cathy Jackson. We'll start with a short introduction and then, we'll go into Q&A.

So, I'll turn it to Frank.

Frank Hall - *Radian Group Inc. - EVP & CFO*

Great, thank you, Lara. I appreciate that very much and thank you so much for having us here at the conference.

For those of you who may be unfamiliar with Radian, let me take a moment to provide a brief overview of our Company, and our financial position, our key credit strengths and we'll forewarn you that our presentation will be loading up here shortly. So I'll speak to some slides that you'll see in just a few moments.

But before we get started, it is important to note that some of the statements we will make today will be forward looking. These statements are subject to certain risks and uncertainties and you should read about these risks that will be illustrated on slides 2 and 3 here shortly.

Our business is comprised of two segments. First is mortgage insurance, and the second is mortgage and real estate services. Mortgage insurance has been our primary segments for many years, and in 2014, we acquired Clayton Holdings, and launched a new mortgage and real estate services segment.

Building upon the Clayton acquisition, we created a solid foundation with future growth opportunities for our Company. Our legacy MI exposure is largely behind us, we have the benefit of projected earnings power from our post crisis mortgage insurance book, and we have a clear focus on our core strengths. Today, we believe we are better positioned to drive long-term value than ever before.

Radian has a strong track record of execution. We will be celebrating our 40th anniversary as a mortgage insurer in 2017. We enjoy a rich history in the industry as a strong and reliable partner. We have many key events in our history that indicate our ability to show strength and deliver quality products and services to our constituents, including the most recent expansion of our services segment offerings with the acquisition of Red Bell and ValuAmerica.

Before I turn it back over to Lara for questions, what you'll see shortly is what we call our value circle, which is a detection of the products and services that Radian and its companies offer, and how we leverage our collective expertise using our complete family of companies to compete effectively.

Our mortgage insurance sales team uses this value circle to show our customers, our existing capabilities in origination, securitization, servicing and loans fulfillment. We use the value circle as a way to differentiate our mortgage insurance company from its peers, similarly these capabilities will serve as our core strengths as we increase our breadth and depth of services within the residential real estate markets.

With that, Lara.

Lara Devieux - *Goldman Sachs - Analyst*

Just for the benefit of those that are not familiar with Radian and overall mortgage insurance industry. I thought it would be helpful, just to take a step back and talk about the products. Really who buys and who pays for the coverage? How long it's in place? How it's sold and really what it covers?

Frank Hall - *Radian Group Inc. - EVP & CFO*

So, mortgage insurance is used to satisfy the credit enhancement requirements by the charters of the GSEs, Fannie Mae and Freddie Mac, on conforming loans with loan-to-value ratios above 80%. Mortgage insurance benefits the consumer by helping them to become homeowners sooner than they could otherwise and in an affordable way. And it benefits mortgage lenders by protecting them against default-related losses. Our industry takes a first loss position and protects a portion of the total loan amount as compared to FHA insurance where the taxpayer is at risk for the entire loan amount in the event of default.

Mortgage insurance premiums can be paid through a number of methods and while the coverage primarily benefits the lender, the premiums may be paid by the borrower or the lender. Borrower paid mortgage insurance is paid by the borrower generally on a monthly basis. Lender paid mortgage insurance is paid by the lender and is typically passed through to the borrower in the form of a higher rate on the mortgage note. While the term of coverage is dependent on a number of factors, the expected life of the loan that we assume for pricing purposes is between 5 years and 5.5 years.

Lara Devieux - *Goldman Sachs - Analyst*

So what is your expectation for the overall mortgage insurance market size over the next couple of years, just given the trend in mortgage originations and also private MI penetration?

Frank Hall - *Radian Group Inc. - EVP & CFO*

Sure. So, mortgage originations and the MI markets have obviously varied over historical periods. An important metric that we use is penetration. And on this slide, slide 8, which you can see illustrated -- and the top left portion of the slide is the overall mortgage origination market and you can see it's bifurcated between purchase and refinance and in the lower left, you can see where the MI penetration is and penetration is the amount of business, our industry writes of the total origination market.

And then on the far right, you can see again for the MI market itself, what percent of it has been purchased and what percent of it has been refinanced. Looking ahead, we expect a total MI market in 2016 to be comparable to 2015. This is based on the expected mix of mortgage activity, which has a projected decline in refinancing to this year that will impact the overall origination volume and we also continue to expect increased penetration from purchase originations. Private mortgage insurance is three to four times more likely to be used for purchase originations than for re-fis.

Lara Devieux - *Goldman Sachs - Analyst*

Okay. So how is Radian differentiated from other mortgage insurance players, not just the legacy companies, but there's also been several new entrants into the market. So how -- I guess and also along with that, what do you expect your market share to be going forward? I think historically it's around the 19%, 20% and do you expect that to grow over time or remain relatively stable?

Frank Hall - *Radian Group Inc. - EVP & CFO*

Sure. So Radian is known as a trusted advisor and partner in the industry and as I mentioned previously, we'll celebrate 40 years of servicing the mortgage lending community. And our products and services and relationships continue to differentiate us among our peers. As I mentioned previously, further differentiation will occur and we will deepen our customer relationships through the services portfolio products that we acquired through the Clayton Holdings acquisition back in 2014. And so, we have introduced hundreds of our MI customers to the products of our services segment and while the overall financial impact from cross-selling these services remains relatively small.

We did generate revenue from 44 customers in the first quarter of 2016. So as we continue to talk to our MI customers about the array of products and services that we have that our competitors don't, we feel that, that will not only solidify our existing relationships, but also provide an opportunity for us to talk about products and services to MI customers that we don't yet have. As it relates to market share, we do expect to be able to grow our market share over time. Recently Radian Guaranty was upgraded to investment grade, which is an important factor of consideration for some of our lending partners. And we expect again just to continue to work hard to develop other key relationships with credit unions and other sectors.

Lara Devieux - *Goldman Sachs - Analyst*

So, there has been some new entrants into the mortgage insurance area, obviously post housing crisis, the returns have been relatively high and so I think they've been attracted to the high profitability. So how have they gained market share just given their short track records?

Frank Hall - *Radian Group Inc. - EVP & CFO*

So, I think the newest entrants have really gained market share through pricing. And that is certainly to be expected. Radian has taken a disciplined approach related to pricing and has shied away from meeting the decreased pricing of some of the newer entrants. But I would say recently with our most recently announced pricing changes there is uniformity and pricing among the industry now. And so, again without a single competitor price advantage, I would say, there is an even playing field, both on the pricing side of the equation, and also with the introduction of PMIERs, the capital requirements across the products, also provides some level playing field as well. So, again, to mention some of the things that I just spoke to, the better and improved client relationships, better and improved products and services, we think will help us gain more market share.

Lara Devieux - *Goldman Sachs - Analyst*

So kind of building on the whole cyclicality of the industry, you guys, as well as the other industry players experience very large losses post the housing crisis. What changes have been made, both on the industry front and the Radian perspective, I'm trying to mitigate the cyclicality, going forward?

Frank Hall - *Radian Group Inc. - EVP & CFO*

Sure. So changes have been made in the broader mortgage industry as well as within the private mortgage insurance industry as well. Loans written after 2008 following the downturn reflected the environment during that time of tightened credit and the reduced appetite by mortgage lenders for taking credit risk. Ultimately, the Dodd-Frank Act establish provisions that continue to rein in the industry and further slow the expansion of credit, including rules around determining a borrower's ability to repay based on certain risk characteristics. This environment has driven the outstanding credit quality of the loans we insure, which is reflected here on slide 10 and the very low loss ratios were experiencing on these books of business.

Also important to mention are the private mortgage insurer eligibility requirements or PMIERs, which are outlines here on this slide, and the following slide. Since the end of 2015, mortgage insurers have been subject to these enhanced capital requirements, which were developed by Fannie Mae and Freddie Mac to strengthen the financial position of the private MI industry.

Radian Guaranty has been in compliance with PMIERs since they became effective. One of the things that we did in order to comply with the PMIERs and increase our financial flexibility was Radian Group transferred approximately $325 million of cash and marketable securities to our operating subsidiary Radian Guaranty, an exchange for a surplus note. We expect to redeem a portion of possibly all of that note in 2016, and any remaining amounts in 2017.

Lara Devieux - *Goldman Sachs - Analyst*

So you alluded to the pricing changes in the industry first by the new players and it seems like now most -- all of the companies are introducing changes to their pricing on certain business. Can you just talk about what rate actions Radian has taken relative to your competitors? And what's the expected implications of these are? I know it's early, but maybe, what your expecting in terms your competitive position, the profile of the book and the financial impact?

Frank Hall - *Radian Group Inc. - EVP & CFO*

Sure. So MI pricing since 2009 has been one of what we call increased granularity, which is using a more risk-based approach that was used in pre-crisis years. And here on slide 13, you can see the progression in our risk-based pricing approach since 2005 for borrower-paid MI. And you can see back in -- as recently as 2005, FICO scores weren't even utilized. And then in 2008 we increased that granularity to just three FICO buckets. And now you can see in April of 2016, we've increased that to eight separate FICO buckets.

And at Radian, really what we remain focused on is, writing as much high-quality new mortgage insurance business as possible while maintaining a well-balanced portfolio mix that we expect to generate a mid-teen levered returns on required capital. And in the first quarter of 2016, we introduced new MI pricing designed to provide increased risk based granularity and to better align with PMIERs and with industry trends. While it's too early to see meaningful results from our new pricing, we are encouraged by the positive feedback we've received from our customers.

Lara Devieux - *Goldman Sachs - Analyst*

Do you expect any shift in your mix of business just based on the pricing relative to the FHA and relative to other competitors?

Frank Hall - *Radian Group Inc. - EVP & CFO*

Yes, I would say the pricing for the most part has stabilized. The production that we're seeing is in line with our expectations. One thing that we have done recently to improve the mix of our retained exposure is to enter into a single premium-only quota share reinsurance arrangement, which has taken our portfolio exposure on single premium product from about 31% down to 25%. So, what that allows us to do is to be able to meet the market demand for the mix of business that the market would like to have that allows us to manage that risk on the back end as far as what the product exposure is in the portfolio.

Lara Devieux - *Goldman Sachs - Analyst*

So, Radian's earnings generation has meaningfully improved over the last couple of years as the legacy book has rolled off and you've been writing attractive new business. I guess, can this trend continue going forward and I guess just discuss your outlook for credit, the loss ratios and defaults rates have trended down pretty meaningfully, so how much further can those decline going forward?

Frank Hall - *Radian Group Inc. - EVP & CFO*

Sure, Cathy, you want to take that?

Cathy Jackson - *Radian Group Inc. - SVP and Corporate Controller*

Sure. So, you mentioned that the two real primary drivers in terms of our earnings at this point are the size of our insurance in-force book, as well as the high credit quality of that book of business. So, in terms of the insurance in-force size, we expect the insurance in-force book to grow over time and expect it to continue to grow this year, given the persistency rates that we're observing as well as the new NIW that we'll write this year.

In terms of the credit quality, Frank pointed to on slide 10, the very low loss ratios that we are observing on business written after 2008. And so that has continued to improve the credit quality of our book. We're continuing to write that business and think that the loss ratios will remain at low levels and so that's going to be a big earnings generator. What you can see here on slide 14 is just in terms of the way the split of the book written since 2008, combined with loans that have been through HARP refinancing is now 85% of our total insurance in-force. So the legacy -- we continue to expect the legacy book to run off and become a less of a portion of our insurance in-force.

Lara Devieux - *Goldman Sachs - Analyst*

So the loss ratio has the potential to improve as if 15% or so runs off, is that accurate?

Cathy Jackson - *Radian Group Inc. - SVP and Corporate Controller*

Correct. The loss ratio on the overall book, what we had shown on slide 10 with loss ratios on new business written by Vintage. So those we don't expect to improve from where they are, they can't get too much lower, but the overall book will improve as the mix shifts towards --.

Lara Devieux - *Goldman Sachs - Analyst*

What's the tail on the legacy book, how many years, would you say would that take to fully run off?

Cathy Jackson - *Radian Group Inc. - SVP and Corporate Controller*

Yes, I think it's difficult to say because some of these older loans has been a little bit more secure than would be in a normal environment, given that some of the legacy loans are still -- they are still underwater in terms of home prices. So maybe need some further improvement in home prices to increase the pace of that run off. But obviously at this point, it's a small portion of the total book.

Lara Devieux - *Goldman Sachs - Analyst*

So you mentioned the recent upgrade of your financial strength rating to IG, what type of business benefits do you think you can see going forward from that upgrade?

Frank Hall - *Radian Group Inc. - EVP & CFO*

So there are some benefits and I would say some of our mid-size regional banks, the credit rating of the mortgage insurance company is still important even though there are capital requirements established under PMIERs that all mortgage insurers must adhere to. So we think that provides us some incremental benefit and would expect to see some modest uptick from that change.

Lara Devieux - *Goldman Sachs - Analyst*

You mentioned your services business to Clayton as a key differentiator. It seems like it's around 15% of revenues, but not a major contributor to earnings. So at what point do you think that could be a positive impact to earnings and also to cash flows?

Frank Hall - *Radian Group Inc. - EVP & CFO*

So, right now Clayton is on a fully absorbed basis, taking care of -- is about breakeven, they are taking care of their interest expense and their allocation of corporate expense. But turning back to the value circle that are our mortgage insurance sales force uses, you'll notice that many of the products and services within this value circle are services -- products and services. So our services segment benefits from a much expanded sales force with the mortgage insurance sales force out there marketing their products as well. So it's hard to say and we have said historically that that business is -- many of its products and services are transactional in nature. So that adds to the volatility of it. But we continue to support it in a meaningful way, we continue to support it through new acquisitions of Red Bell and ValuAmerica. Last year we continued to support it through helping them innovate and create new products and services. So we're optimistic about it, timing is just the top point to gauge.

Lara Devieux - *Goldman Sachs - Analyst*

So just turning for the balance sheet. Radian issued $350 million of senior debt in the first quarter to take out a large portion of the converts. Are there opportunities to further simplify the capital structure and maybe just talk about your leverage target, where do you expect it to go versus the current debt-to-cap level?

Frank Hall - *Radian Group Inc. - EVP & CFO*

Sure. So here on slide 15 is an overview of our capital structure, including the convertibles which you just mentioned. We have largely completed the capital plan that we outlined last year where we are seeking to improve our capital structure by removing the convertible notes, distributing the debt maturities more evenly. And we also are continuing down the path of returning to investment grade, which means taking our debt to total capitalization below 30%. So in the near-term though, our focus is on redeeming the previously mentioned surplus note in the near-term, and just continue to work away at reducing the exposure from the convertibles. So we think we are on a good path there.

Lara Devieux - *Goldman Sachs - Analyst*

I noticed that the 2017 maturity, mid-2017, 5% or so, if you're looking -- have you commented on whether or not you would look to refinance or just take that out of the cap structure to kind of get to the less than 30% debt-to-cap?

Frank Hall - *Radian Group Inc. - EVP & CFO*

Yes, so the expectation is that the cash flows that we're expecting at the Parent Company should be sufficient organically to take care of all the 27 teams. So at the end of the quarter, we had roughly $390 million of Parent Company cash. We stated a target of between $300 million and $350 million. Again, the purpose of that target is to make sure that we have sufficient holding company liquidity to deal with any single-year debt maturities, which is something that the rating agencies have encouraged us to do. So, given the fact that we are likely to redeem the $325 million surplus note in the near-term, that gives us a pretty healthy sum of cash at the Parent Company.

Lara Devieux - *Goldman Sachs - Analyst*

So, we're turning to -- following up on the liquidity comments. Once you redeem the surplus notes up to $325 million, you're going be well over your target liquidity. You did mention, you would have sufficient liquidity to pay down the 27 notes, but I guess what are the expected uses of that holding company liquidity? And how comfortable are you and how quickly would you look to bring that down towards your targeted range?

Frank Hall - *Radian Group Inc. - EVP & CFO*

So the expected near-term uses, again, sources would be the surplus note, uses would be the upcoming maturities of the 27 teams, and also to the extent, we can be opportunistic around the convertible notes as well. That's roughly $400 million in total, roughly of the November 27 converts of 2019 converts, and the June 2017 senior notes. So we think after all of that is done, that should certainly bring our debt to total capitalization level below the 30%.

Lara Devieux - *Goldman Sachs - Analyst*

And then longer term, what are your future sources of liquidity to the holding company? Usually, insurance companies are able to dividend money from the operating companies, but I think you're somewhat limited there. So going forward, what are the expected sources?

Frank Hall - *Radian Group Inc. - EVP & CFO*

Yes, so we're fortunate to have a longstanding and approved arrangement with the Pennsylvania Department of Insurance, whereby we can upstream interest payments, and we have an expense sharing arrangement as well. So, and that has withstood the financial crisis as well. So the cash flow to service debt is readily available. But to your point, we are eventually expecting through organic earnings to work our way out of the deficit position that we have in the insurance company to be able to eventually start paying dividends to the Parent Company, but that is probably six or seven years away. So, but we do have sufficient cash flow to, again, meet all of our obligations and our relationship with the State of Pennsylvania has been a very good and very strong relationship over time.

Lara Devieux - *Goldman Sachs - Analyst*

So those, the money from the Pennsylvania, is that extraordinary type of dividends or what's the form of that as well?

Frank Hall - *Radian Group Inc. - EVP & CFO*

Right. So if we were to do anything before the negative unassigned surplus is reduced, it would require a special dividend.

Lara Devieux - *Goldman Sachs - Analyst*

So the Radian stock prices is down this year. And how do you balance the interests of bondholders and shareholders and do you foresee a share buyback program, I believe you may have done small one, but they are more pressured to do larger share buybacks?

Frank Hall - *Radian Group Inc. - EVP & CFO*

We did a share repurchase this year of about $100 million and the purpose for that was to really take advantage of a very low share price, it was in the context of the overall capital plan that we announced. So it was, I would just say, we altered the timing of something that we expected to do anyway. As it relates to ongoing uses of capital, it's something that certainly will have a bias towards preserving capital for organic growth. And we certainly may take a look at opportunistically share repurchases and dividends. But I think some of those conversations are ways away.

Lara Devieux - *Goldman Sachs - Analyst*

So, you commented your goal to move the debt ratings to investment grade. Besides reducing leverage what other factors will drive those upgrades and how are the discussions with the rating agencies, how often and I guess the potential timing for return to IG.

Frank Hall - *Radian Group Inc. - EVP & CFO*

Yes, timing is difficult to estimate as you might imagine, some of the other activities are really, I would just say, further steps along managing a capital structure consistent with an investment grade rated company. So it's moving up the debt maturities, again, continuing to clean up the types of dent that are in the capital structure, the amount of debt et cetera, and just providing greater certainty and clarity around the overall financial health of the organization.

Lara Devieux - *Goldman Sachs - Analyst*

Does anyone have any questions from the audience?

QUESTIONS AND ANSWERS

Unidentified Audience Member

Hi, you guys mentioned the reinsurance and some others in the industry have been talking about reinsurance as well. Can you just give us a little more flavor of how attractive that is, the cost of capital, how you guys compare it to retaining the business internally.

Frank Hall - *Radian Group Inc. - EVP & CFO*

Sure. I would say the reinsurance market is very strong right now and the cost of capital on this particular transaction was very attractive. So, it was in the low single digits on this particular transaction.

Lara Devieux - *Goldman Sachs - Analyst*

Are there opportunities for further reinsurance?

Frank Hall - *Radian Group Inc. - EVP & CFO*

Yes, the way that we look at reinsurance is more so to make sure that we're managing the risk return characteristics of the portfolio overall. So, for this particular transaction, it was a singles-only transaction. We wanted to see the effect of exposure to the single premium business reduced a little bit and as I mentioned earlier, we also want to be positioned to meet the market demand for that particular product. So I would say this transaction is indicative of the way that you should expect to see us use reinsurance just on a very strategic and risk based fashion.

Lara Devieux - *Goldman Sachs - Analyst*

Any other questions? So, I'll ask one or two more. Just any regulatory developments on the horizon that could be viewed as an opportunity or a risk for Radian and just the overall MI market?

Frank Hall - *Radian Group Inc. - EVP & CFO*

Sure. There are, I would say, conversations that happen from time to time and topics that gets picked up and reported on deeper coverages, one, in certain forms that could be beneficial to the MI industry. Other things on the regulatory front, I would say are probably -- it's probably too soon to estimate impact of any of those.

Lara Devieux - *Goldman Sachs - Analyst*

Last question I have just another large player United Guaranty is most likely going to go public this year. Just any sense on potential implications, the competitive dynamics of them being a publicly traded company versus being owned by AIG?

Frank Hall - *Radian Group Inc. - EVP & CFO*

Yes, we actually see that very positively, the increased transparency into that organization is certainly helpful from a competitive standpoint. We also think that increased transparency may provide an opportunity for others to see a little bit more how they've priced their business, how they structure their business et cetera. So I think just transparency in the competitive landscape overall is good.

Lara Devieux - *Goldman Sachs - Analyst*

Okay, Great. Well, thank you very much.

Frank Hall - *Radian Group Inc. - EVP & CFO*

Thank you very much for having us. I appreciate it, thank you all for your time and attention today.
