

## GREAT-WEST LIFE CO (GWO - TSX - \$32.15)

**Recommendation**

BUY

**Risk**

Low

**Target Price**

\$40.00

**Price**

\$32.15

**52-Week Range**

\$30.51 - \$37.70

**% Below High**

-14.7%

**% Above Low**

5.4%

**Shares O/S**

894 million

**Market Cap**

\$29 billion

**Average Daily Volume**

517,701

**Year-End**

December 31

C\$	EPS	Multi.
2007a	\$2.42	13.3x
2008e	\$2.70	11.9x
2009e	\$2.95	10.9x
Book Value	\$10.98	2.9x

	Amount	Yield
Dividend	\$1.17	3.6%

**Analysts**

Robin Cornwell



Data Source: www.BigCharts.com

### Q4/07 EARNINGS MISS MAINLY DUE TO CURRENCY BUYS U.K. PAYOUT ANNUITY BLOCK FROM STANDARD LIFE DIVIDEND INCREASED 6%

#### CONCLUSION: BUY – 12 MONTH TARGET LOWERED TO \$40.00

Great-West Lifeco (GWO) reported Q4/07 EPS (fd) of \$0.60 up 9% Y/Y and \$0.03 below our expectations. The currency impact was significant such that on a constant currency basis EPS would have been \$0.64 up 17% Y/Y. The quarter included 3 months of Putnam with the contribution to GWO's earnings slightly lower than expected with net redemptions higher than expected. Adjusted ROE decreased modestly to 21.9% in the quarter. Dividend per share increased to \$1.17 annually from \$1.10 up 6%.

For 2007 as a whole GWO reported adjusted EPS (fd) of \$2.42 per share up from \$2.11 in 2006, a gain of 15%. However on a constant currency basis net income would have been \$0.03 per share higher and the earnings growth would have been closer to 16% for the year. ROE for 2007 was 21.6% up from 20.1% in 2006. Dividends in 2007 were increased by 15%.

GWO announced yesterday, the acquisition of another add-on U.K. payout annuity block from Standard Life. We expect this business to be accretive to 2008 EPS by an estimated \$0.04. In addition, the pending sale of the Health Care unit announced previously is considered a positive move for GWO as it has been struggling for scale and profitability. This deal completes the financing for Putnam with no need for equity financing. However, and far more significant, is

that we expect the growth potential from Putnam will be greater than that which would have been generated from the stagnant Health Care unit. We see this deal as reinforcing managements focus on the wealth management (retirement) sector in the U.S.

We are lowering our 2008 EPS estimate for GWO to \$2.70 from \$2.77 due to weaker equity markets, our lower expected AUM forecast and the stronger \$C currency. We have also introduced our 2009 estimate at \$2.95, a 9% increase over 2008. ROE is expected to remain strong at near the 20% to 21%. We expect a trailing dividend payout ratio of 47% to 50% which would suggest further dividend increases over the next 12 months to the \$1.30 level for an increase of 11%. We maintain our BUY recommendation.

### **Valuation**

We have lowered our 12 month target share price for GWO to \$40.00 from \$41.50 based on the modestly slower earnings outlook. We believe GWO represents a solid, low risk, global growth opportunity using an “add-on” acquisition strategy focused on the wealth management sector. In addition to the Putnam transaction, GWO has made five other add-on acquisitions which collectively we expect to be significantly accretive to 2008 EPS. More significant is our expectation that GWO may make several more of these add-on acquisitions over the next 12 months and further enhance EPS in 2008 and 2009. We continue to highly endorse this strategy. Our valuation also recognizes the good constant currency underlying earnings growth at GWO and the significantly higher yield of 3.6%. Our total expected return over the next 12 months for GWO is 28.1%.

### **Putnam Update – First Full Quarter**

Putnam contributed net earnings of US\$27 million or \$0.03 per GWO share for the quarter. On a standalone basis excluding restructuring charges Putnam reported net income of US\$50 million and US\$81 million before tax and non-controlling interest. The gross margin was 25.4%. This included about US\$5 million of seasonal adjustments including performance fees. Management is working towards eliminating more administrative expenses as well as increasing its institutional book of business which looks very promising. Both should allow for an improvement in margins closer to the 30% level. The retail turnaround will take longer as we expected.

As at the end of the quarter total AUM was US\$186 billion down from US\$191 billion at the end of the previous quarter of which US\$105 billion were long-term AUM (US\$113 billion last quarter), US\$8 billion short-term (US\$4 billion last quarter), and the balance institutional US\$74 billion (unchanged). Putnam reported net redemptions in the period of US\$2.6 billion (excluding Money Market) and negative market performance of US\$5.9 billion. Money Market saw net inflows of \$3.0 billion.

### **Stronger C\$ Could Now Be A Drag On EPS**

Given the recent strength of the C\$ relative to the US\$ (approximately 27% of GWO’s earnings are sourced in the U.S.), and assuming the C\$ stays closer to the \$1.00 level the impact on GWO could be negative by some 2% on 2008 EPS (\$0.02 to \$0.03 per share).

### **Recent Events**

1. **U.S. health care division to be sold to CIGNA Corp.** GWO has agreed on a price of US\$2.25 billion with after-tax cash proceeds of US\$1.6 billion. Management indicated that it will use the proceeds to repay financing associated with the Putnam purchase. The transaction is expected to close in mid-2008.

- U.K. Payout Annuity Block From Standard Life** - Accretive to 2008 EPS by an estimated \$0.04. GWO announced on February 14, 2008 that it signed an agreement with Standard Life Assurance Limited in the U.K. to assume by way of indemnity reinsurance, a large block of U.K. payout annuities. The business will be acquired by its wholly owned UK subsidiary Canada Life Limited. This transaction will increase policyholder liabilities by approximately C\$13 billion. We estimate that this acquisition will bring the total annuity block managed by Canada Life to almost C\$35 billion.

### Other Quarterly Highlights

- In Canada, Q4/07 net income was \$246 million up 10% Y/Y. Operating expenses were down 2% Y/Y providing positive operating leverage.
- U.S. division was weaker than expected and reported a 4% increase in \$US net income excluding Putnam and a 10% increase including a full quarter of Putnam.
- Europe reported weaker Q4/07 net income of \$150 million or flat Y/Y. On a constant currency basis net income rose 10%. Sales in the U.K. were down 42% Y/Y while sales in Germany & Ireland decreased 5% Y/Y. The lower U.K. sales in the quarter resulted from a decline in single premium bonds sales in reaction to proposed U.K. budget changes. The acquisition of the Standard Life annuity payout block should be a positive in 2008 as will rolling over of Equitable Life block (see below).

### Subprime Lending Exposure & Monoline Exposure – Minimal Concern

**Subprime Exposure:** Management stated that GWO has approximately US\$1.5 billion of ‘AAA’ rated home equity subprime investments in various pools representing 1.5% of its total invested assets. Most of the loans (65%) were originated prior to 2006 and all are fixed rate in nature. Management indicated that there was equity of about 30% below GWO’s investments. None of the investments have been subject to credit rating downgrades.

**Monoline Exposure:** GWO has \$3.5 billion in Monoline exposure largely wrapping bonds that are government and utility related. Geographically the exposure is Canada (6%), U.S. (36%), Europe (58%). Monoline insurers are Ambac (35%), MBIA (32%), FSA (16%), FGIC (15%), XL (2%). Management expects little impact from the default of any of these insurers.

### Previous Payout Annuity Transactions In The U.K.

**U.K. Payout Annuity Block From Equitable Life** - Accretive by \$0.03 per share to 2007 EPS. GWO announced the acquisition of a UK \$9.3 billion block of annuity business (130,000 policies) from Equitable Life. The business will be acquired by its wholly owned UK subsidiary Canada Life Limited which acquired the Phoenix block of annuity business just a year ago. This acquisition increased the total annuity block managed by Canada Life to almost C\$20 billion. Less than 50% of the \$3.0 billion of the payout annuity block of business purchased from Equitable Life has been reinvested under the yield enhancement strategy initiated when the block was acquired. Although reinvestment is happening at a slower rate than expected, the good news is that the recent credit problems seem to be widening potential spreads going forward from the 70bp pick-up in spread achieved to date to the 100bp to 125pb level. We expect further benefits to accrue as the balance is gradually reinvested in higher yielding securities.

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