

GREAT-WEST LIFECO (\$31.52 GWO-TSX)

Recommendation

Buy

Risk

Low

Target Price

\$39.00

Price

\$31.52

52-Week Range

\$27.46 - \$37.67

% Below High

-16.3%

% Above Low

14.8%

Shares O/S

894 million

Market Cap

\$28 billion

Average Daily Volume

20 day: 583,200

Year-End

December 31

C\$	EBITDA	Multi.
2007a	\$2.42	13.3x
2008e	\$2.60	12.1x
2009e	\$2.90	10.9x
Book Value	\$10.98	2.9x

	Amount	Yield
Dividend	\$1.17	3.7%

Analysts

Robin Cornwell B.A. (Economics),
MBA



Data Source: www.BigCharts.com

Q1/08 – SLIGHT EARNINGS MISS

CONCLUSION: BUY – 12-MONTH TARGET LOWERED TO \$39.00

Great-West Lifeco (GWO) reported adjusted Q1/08 EPS (fd) of \$0.60, up 4% Y/Y and \$0.03 below our expectations. These earnings exclude an after-tax net gain of \$118 million (\$0.13 per share) in connection with several non-recurring items. The currency impact was significant, such that on a constant currency basis EPS would have been \$0.65 up 13% Y/Y. Putnam’s earnings were lower than expected, declining by \$0.03 per GWO share as Assets Under Management (AUM) declined by 10% Y/Y and net redemptions of long-term funds increased. Adjusted ROE decreased modestly to 21.1% in the quarter, down from 21.9% last quarter.

The recently announced acquisition of another add-on U.K. payout annuity block from Standard Life is expected to be accretive to 2008 EPS by an estimated \$0.04. However, we no longer expect the earnings from the Putnam acquisition in fiscal 2008 to offset the loss of earnings from the recent sale of the Health Care unit which is disappointing. Longer term, we continue to expect the growth potential from Putnam will be greater than that which would have been generated from the stagnant Health Care unit. We continue to see the Putnam deal as reinforcing management’s focus on the wealth management (retirement) sector in the U.S. and continue to highly endorse this strategy. Patient investors should be well rewarded beyond fiscal 2008.

We are lowering our 2008 EPS estimate for GWO to \$2.60 from \$2.70 due to weaker equity markets, our lower expected AUM forecast and the impact of the stronger \$C currency. To err on the side of caution, we have lowered our 2009 estimate modestly to \$2.90 from \$2.95 as we expect better results at Putnam and wider spreads (see quarterly highlights below) on the roll-over of the annuity book in the U.K. Our 2009 EPS estimate represents a 12% increase over 2008. ROE is expected to remain strong at near 20%.

We expect a trailing dividend payout ratio of 47% to 50%, which would suggest a more modest dividend increase over the next 12 months to the \$1.25 to \$1.30 level for an increase of 7% to 11%. However, based on next year's EPS outlook, we expect the dividend could increase by 10% to 15% in fiscal 2009. We maintain our BUY recommendation.

Valuation

We have lowered our 12-month target share price for GWO to \$39.00 from \$40.00, 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 2009 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 both 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 3.7%. Our total expected return over the next 12 months for GWO is 27.5%.

Putnam – Major Earnings Drag But Improvement Expected

Putnam had a very difficult quarter and contributed net earnings of US\$3 million or nil per GWO share, down from US\$27 million last quarter or \$0.03 per GWO share, well below our estimate of US\$22 million. On a stand-alone basis excluding restructuring charges, Putnam reported net income of US\$24 million (after-tax and non-controlling interest), down from US\$50 million last quarter. The gross margin in the quarter was 14.2%, down from 25.4% last quarter. The variance in the quarter resulted from:

- US\$14 million after-tax earnings caused by the decline in AUM and a shift in AUM to institutional from retail whereby institutional AUM support lower fees.
- US\$15 million after-tax earnings from lower performance fees and lower investment income.
- An offset of about US\$6 million was due to better expense control.
- The previous quarter had about US\$8 million in performance fees, which is seasonal in nature.

Management suggested that the 14.2% margin would normalize to 19.2% if non-recurring items are removed from the quarter. Management reiterated that more administrative expenses can be eliminated and that growth in the institutional book of business looks very promising. Margins are very sensitive to AUM performance and we expect longer term that margins will improve closer to the 28% to 30% level. The retail turnaround will take longer than we expected, but further acquisitions should not be ruled out. The reduction of debt financing (see Recent Events below) associated with the Putnam acquisition should reduce financing costs by about US\$6 million on an after-tax basis per quarter.

As at the end of the quarter, total AUM decreased by 10% Q/Q and Y/Y to US\$168 billion from US\$186 billion at the end of the previous quarter. Net flows accounted for the loss of US\$3.7 billion, while market performance accounted for the loss of US\$13.9 billion of AUM. Money Market saw net inflows of \$0.3 billion.

Management Changes

1. Robert Gratton steps down as Chairman of the Board of Great-West Lifeco and its major subsidiaries and is replaced by Raymond McFeetors, formerly President and CEO of Great-West Lifeco and its major subsidiaries.
2. Allan Loney replaces Raymond McFeetors as CEO of Great-West Lifeco and its major subsidiaries. Allan Loney was formerly Executive Vice-President, Chief Actuary / Capital Management.

Other Quarterly Highlights

- In Canada, Q1/08 net income was \$245 million, up 11% Y/Y. Operating expenses were up 1% Y/Y providing positive operating leverage.
- U.S. division was weaker than expected and reported a 4% decrease in \$US net income excluding Putnam (see discussion above). The weaker results reflected a 13% decline Y/Y in Health Care, which has now been sold. Excluding Health Care, US\$ net income was down 1% Y/Y.
- Europe reported a stronger Q1/08 with net income of \$175 million up 19% Y/Y. On a constant currency basis, net income rose 36%. Sales in Ireland/Germany were down 29% Y/Y due in part to the introduction of a new contract law in Germany which affected the timing of how sales are reported. The acquisition of the Standard Life annuity payout block should be a positive in 2008 as will the rolling over of the Equitable Life block. We expect significant spread improvement as the payout annuity blocks of business are reinvested under a yield-enhancement strategy initiated by management. 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 by over 50%.

Recent Events

1. **U.S. Health Care Division to be sold to CIGNA Corp.** GWO announced on April 1, 2008 that the sale of its U.S. Health Care business was completed for a price of US\$2.25 billion with after-tax cash proceeds of US\$1.6 billion. Management indicated that it applied approximately \$1.1 billion of the sale proceeds to reduce its outstanding bank bridge facility, of which approximately \$0.6 billion remains.
2. **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 had 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 U.K. 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.

Subprime Lending Exposure & Monoline Exposure – Minimal Concern

Subprime Exposure: Management previously 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.

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.

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