

Recommendation

Buy

Target Price

\$40.50

Risk

Low

Average Daily Volume

20da:375,300/150da:558,000

Quick Facts

Recent Price C\$34.25
Symbol GWO-TSX
Shares O/S 892 million
52 Wk. Range \$28.13-\$37.70
Year End December 31

	EPS	Multiple
2006a	\$2.11	16.2x
2007e	\$2.46	13.9x
2008e	\$2.77	12.4x
Book Value	\$11.31	3.1x

	Rate	Yield
Dividend	\$1.10	3.2%

Great-West Lifeco



Data Source: BigCharts.com

Great-West Lifeco Inc. is a holding company. It owns 100% of the outstanding common shares of Great-West Life Assurance Co. of Winnipeg.

CONCLUSION: BUY – 12 MONTH TARGET MAINTAINED AT \$40.50

Great-West Lifeco (GWO) reported Q2/07 EPS (fd) of \$0.61 or about \$0.01 ahead of our expectations, up 17% Y/Y. European earnings were particularly strong. The recent add-on acquisitions in Europe and the U.S. are now beginning to show positive results and have further potential as payout annuity assets are reinvested at higher rates. The Putnam transaction is expected to now close in Q3/07 (was expected in Q2/07) and no further details were given as to the financing of the transaction other than there seems to be no rush. ROE increased to 21.9% in the quarter. Dividend per share was increased to \$1.10 annually (\$0.275 quarterly) from \$1.02 (\$0.255 quarterly), a 8% increase. Total dividend increase on a Y/Y basis is 15%.

We are maintaining our 2007 and 2008 EPS estimates for GWO of \$2.46 and 2.77 respectively. The estimates include the recently announced Putnam deal expected to close very soon. ROE is expected to remain strong at near 21%. The recent strength of the \$CDN relative to the \$US is now expected to create a drag on EPS in the second half of 2007 rather than being just neutral. In any case, we believe investors will begin to realize more earnings benefits from U.S. and Europe. We expect a trailing dividend payout ratio of 47% to 50% which would suggest further dividend increases over the next 18 months to the \$1.35 to \$1.40 level (annualized at about 18%). We maintain our BUY recommendation.

Valuation

We are maintaining our 12 month target share price for GWO at \$40.50 based on what we believe is a solid, low risk, global growth opportunity using an “add-on” acquisition strategy focused on the wealth management sector. In addition to the recently announced Putnam transaction, GWO over the last 12 months has made four add-on acquisitions (see below). On a cumulative basis these transactions are expected to be accretive to 2007 and 2008 EPS by \$0.06 to \$0.07 per share with the Putnam deal adding a further \$0.06 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. 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 3.2%. Our total expected return over the next 12 months for GWO is 21.6%.

U.S. Subprime Lending Exposure – US\$1.2 Billion With 99% Rated ‘AAA’

Management indicated that GWO has approximately US\$1.2 billion of ‘AAA’ rated home equity subprime investments in various pools representing 5% of its total U.S. assets. Most of the loans 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.

Update On Proposed Putnam Transaction

GWO announced in February that it had reached an agreement with Marsh & McLennan Companies Inc. whereby GWO will acquire the asset management business of Putnam Investment Trust. The purchase price is US\$3.9 billion payable in cash. Closing was expected in Q2/07 but now is expected this quarter. All government approvals have been received and final documentation is being prepared. Management gave no further update on its financing options with respect to the deal (at the time of the announcement management indicated that there would likely be a \$1.2 billion common equity issue by GWO), but did indicate that it was comfortable with bridge financing until permanent financing was secured. Only a portion of the purchase price has been hedged and therefore GWO will benefit from the recent strength in the \$CDN relative to the \$US. If alternative financing were to be put in place and therefore eliminating the need for a common equity issue, we could see further accretion to our 2008 EPS estimate of up to \$0.05 per share in addition to \$0.06 per share accretion expected from the acquisition itself.

Stronger \$CDN May Now Be A Drag On EPS

Given the recent strength of the \$CDN relative to the \$US, and assuming the \$CDN stays closer to the 1.05 to 1.07 (93 to 95 cent) versus the 1.11-1.13 (88 to 90 cent) level that we had previously expected, the impact on GWO will be negative by 1% to 2% on overall EPS rather than the neutral impact previously expected. For all of 2006, GWO experienced a \$132 million erosion of its earnings (\$0.15 per share or 7%).

Other Quarterly Highlights

- In Canada, Q2/07 net income was \$245 million up 14% Y/Y, excluding a \$20 million tax benefit last year. Results were helped by individual life sales up 6% Y/Y, strong group retirement up 47% Y/Y, good seg. fund sales up 24% Y/Y and lower operating expenses. The operating expenses were down 1% Y/Y. Credit quality remained good in the quarter with net non-performing loans stable at \$15 million.
- U.S. division reported net income of \$136 million up 7% Y/Y. Sales of 401k plans were up 168% Y/Y due to the recent acquisitions of 401k business blocks from MetLife and US Bancorp (as discussed below). Fee income on AUA was up 63% Y/Y also driven by the 401k assets recently acquired. Healthcare net income was reported at \$50 million up 64% Y/Y however sales fell and there were over 160 net case outflows up five-fold from the experience last year. Many of the lost cases were however smaller in size and thought to be less profitable. The healthcare market remains very competitive and this is not expected to change in the near term.

- Europe reported a very strong Q2/07 net income of \$153 million up 59% Y/Y. Sales in the UK were flat Y/Y while sales in Germany & Ireland increased 124% Y/Y. Europe also benefited from higher renewal rates in Reinsurance. Approximately 25% of the \$3.0 billion of the payout annuity block of business purchased from Equitable Life has been reinvested at a 60bp pick-up in spread and we expect further benefits to accrue as the balance is gradually reinvested in higher yielding securities.

Recent GWO Transactions - Accretive To 2007 EPS by \$0.06

1. US 401(k) Block From US Bancorp – Accretive by \$0.01 to \$0.02 per share to 2007 EPS. In December, 2006, GWO announced the acquisition of the 401(k) business of US Bancorp. The deal adds \$9 billion of assets, 1,900 plans and 195,000 participants. Assets now total almost \$30 billion with 7,100 plans and almost 1 million participants.
2. US 401(k) Block From MetLife - Accretive by \$0.01 to \$0.02 per share to 2007 EPS. In June, 2006, GWO announced the acquisition of the 401(k) business from MetLife. The deal adds US\$8 billion in AUM. Included and perhaps equally important is that the acquisition included the associated dedicated distribution group including wholesalers, relationship managers and sales associates.
3. UK Payout Annuity Block From Equitable Life - Accretive by \$0.3 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. We estimate that this acquisition will bring the total annuity block managed by Canada Life to almost \$20 billion. We estimate the current spread on this type of business is close to 40bp, however we expect that through yield enhancement techniques this return could rise by 50% plus.
4. Benefit Management Corp – a small third party administrator of employee health plans. Expected to be accretive to EPS by \$0.01 in 2008. This is a Montana based company that GWO has an agreement to purchase 80%. The transaction will add almost 90,000 medical members to GWO's U.S. Healthcare division. Closing is expected in Q2/07.

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