

Western Financial offers chance for big score

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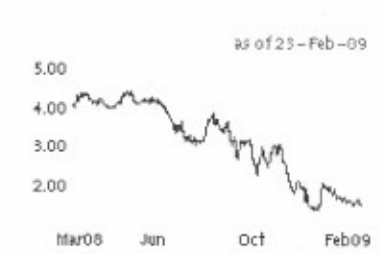
High River, Alta., is a long way from Wall Street, a longer way from London and even farther from Eastern Europe, which is apparently on the verge of financial collapse.

But the hamlet is not immune to what's going on out there, nor is its biggest corporate citizen, Western Financial Group. Once a darling small-capitalization firm that delivered fat returns to investors, WFG shares have cratered, losing about three-quarters of their value in a year and a half, even as the company maintains decent profitability.

Trading well below book value (roughly at book if you strip out goodwill and intangibles), is the stock attractive? If you believe in the business model and the people executing on it, it looks like a good one to put on your radar.

There are four legs to the WFG stool. The first and biggest is The Network, a string of property and casualty (P&C) insurance brokerage offices in small towns across Western Canada. The Network generated about 60 per cent of revenue in the first six months of 2008.

Western Financial Group



Next is Western Life, a life insurance concern. It makes up roughly a quarter of revenues.

Then there's Bank West, a Charter 1 virtual bank that lends mortgage money and makes recreational vehicle and farm loans. It's responsible for a little less than 15 per cent of revenue.

The final leg is a minority stake in Jennings Capital, a Calgary-based investment dealer. (This part of the business is an equity investment, so while it does contribute profits, at least in good times, it doesn't add to revenues.)

The Network is, understandably, the backbone of the operation. P&C insurance is like groceries, utilities and shelter: You always need it. Is it recession-proof? Not entirely, but it's far less discretionary than most

things you can invest in. When capital markets are strong, underwriting P&C becomes competitive and unprofitable, so 2008 won't be a great year for the industry over all.

But conditions are firming because insurers aren't making much by investing the premiums they collect, so they have to charge more. As a broker, WFG earns commissions based on premiums, so higher premiums mean higher commissions, which will help the bottom line. As the economy slows, there will be less demand for insurance, but The Network will remain solid. Yet, as CEO Scott Tannas told me recently, "investors ignored our core business in good times and they're ignoring it now."

The life insurance unit is also a solid performer. WFG bought the business from Northbridge in 2005 – "one of the best deals we ever did," Mr. Tannas says. The numbers bear him out: In the first nine months of last year, operating income was up 40 per cent as the subsidiary's offerings were flogged to WFG's broader client base. The problem with this business is that it's subject to investment losses from capital markets, but by and large it benefits from a lack of competition in Canadian life insurance.

Bank West is the swing factor: Mr. Tannas says his opportunities lie where the big banks don't want to go, which is an expanding territory right now. He also thinks better customer service is a selling point, and most of us can appreciate that. WFG just closed the acquisition of a small agri-finance company, which will boost revenue. There may be other acquisition opportunities as small financiers struggle to raise capital.

But the question mark hovers over that loan book. About a third of it was advanced to buyers of boats and recreational vehicles – not the most solid collateral and presumably the kind of things consumers will jettison first. A little more than half is commercial and residential mortgages, with the rest lent to farmers.

Mr. Tannas doesn't look concerned when he describes the book, which at around \$370-million, including the recent acquisition, is almost twice WFG's equity and five times tangible equity. A 10-per-cent writedown would wreak havoc.

But if the market is thinking about writedowns of that magnitude, it seems overdone. It's certainly unprecedented. Meantime, the rest of the business, run by capable, conservative people who own a lot of stock, churns out profits and a decent dividend.

The fourth-quarter and annual results will shed more light on that loan book. But the stock is worth watching. Small and far from the centre of universe, it's the kind of investment that can get ridiculously cheap – and it might.