

NATIONAL WESTERN LIFE -CL A NWLI

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by [REDACTED]

			2012	2013
Price:	139.00	EPS	\$22.00	\$24.00
Shares Out. (in M):	4	P/E	6.3x	5.8x
Market Cap (in \$M):	505	P/FCF	0.0x	0.0x
Net Debt (in \$M):	0	EBIT	0	0
TEV (in \$M):	505	TEV/EBIT	0.0x	0.0x

Description

NWLI is a life and fixed annuity insurance company. Historically it has been well run, it has a very conservative balance sheet (cash, no debt) and is currently trading at a significant discount to GAAP book value and a large discount to "mark to market" book value and a P/E of around 6. We believe the current price provides for an excellent entry point for long term value investors.

We believe a fair value for the stock in 15 months is 200 or approximately 40% upside. This does not incorporate any shareholder friendly actions such as share repurchases which could increase the fair value considerably. The catch is that there are no immediate catalysts that we are aware of to drive the stock price higher, so there is dead money risk.

The Market Capitalization of NWLI is approximately \$500mm and book value is \$1331mm for a price/book of below 0.40x. This corresponds to a book value per share of 366 versus a current share price of 139. While most life insurers trade below book value today due to valid concerns (interest rates, low ROE, etc) one key difference between NWLI and most other life companies is that NWLI designates a large portion of its bond portfolio as held to maturity which does not get marked to market thru the balance sheet and does not get picked up in book value. The unrealized gain on the HTM portfolio is currently \$461mm or approximately \$127 per share of "hidden value" for a total "adjusted book value" of 493 (price to "adjusted book value" of below 0.3x). This difference is hard to pick up without reading the company filings and leads to the stock not screening as cheap versus peers. The total lack of analyst coverage and non promotional management help keep this discount in place.

NWLI operates in two main insurance lines - domestic fixed annuities and international products (annuities and life insurance). The annuities business is fixed index deferred annuities and flexible premium annuities which are relatively low margin and low ROE businesses due to low interest rates and high competition. In general these products provide customers a minimum rate along with a kicker tied to the returns on an equity index. The company purchases equity index call options to hedge this risk. This business does not have the same type of downside risk as the variable annuities business for insurance companies. The international business is a higher ROE business and is growing well. It provides annuities and life insurance to wealthy customers around the world. This business is much less commoditized and generates a higher ROE (target of 10-15%) and higher ROA (2.0%). The company is currently generating a blended 7% ROE which is one major reason for the low price/book value.

NWLI is run and controlled by the Moody Family who own approximately 1/3 of the stock and control the board via a dual class structure (they also control ANAT). This is a key risk for the stock as the company currently has very little desire to do shareholder friendly actions (share buybacks, dividends, etc). From our conversations with management and members of the board of directors this all due to the 76 year old Chairman/CEO who frankly runs this as a private company. It is our understanding that the President (Chairman's son), CFO, and various board members would be open to ways to enhance shareholder value and improve the stock price but a real risk to this investment is that this is a value trap.

Having said that, under the leadership of Mr. Moody the company has compounded book value by approximately 12% a year over the past 20 years with only one year of book value decline (3% decline in 2008). The investment portfolio is very conservative with mostly corporate bonds and agency mortgages. The credit losses on the investment portfolio have been very low over the past 10 years. Unlike many other insurance companies NWLI did not have a near death experience in 2010 due to the very low leverage employed (RBC ratio at year end was 686% which is much higher than peers) and clean balance sheet.

This opportunity has come up because over the past few years large shareholders such as Third Avenue (the small cap fund) have been selling their positions. While there are no hard catalysts on the horizon nor do we expect the stock to trade to book value anytime soon we believe a conservative fair value is closer to .50x book value by the end of 2013 (blend of higher P/BV for international business and low P/BV for the domestic annuity business). Using our estimate of book value of \$400 at the end of 2013 this provides a year end price target of 200 or approximately 40% upside.

It is important to note that this does not incorporate any of the hidden book value highlighted earlier or any shareholder friendly initiatives that management can employ. While we are not expecting any management actions in the near term, any shareholder friendly actions (dividend, share repurchase, tender, sale of company etc) can lead to a significantly higher share price.

There are several key risks with this stock including:

Illiquidity (less than \$0.5mm value is traded each day)

Controlling shareholder (CEO) with little demonstrated desire to increase share price

Brazil lawsuit (the regulators are suing NWLI and from discussions with the company this should have no impact on capital, the growth of the new business in Brazil could be material if customers decide to stick with domestic insurers).

Low and volatile interest rates (Low interest rates makes it difficult to generate acceptable returns and sharply higher interest rates can lead to policyholder surrenders).

Catalyst

Death or retirement of CEO

Share buybacks / dividends

Expansion of International Operations

Steady increase of interest rates