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## **Analysts' Ideas of the Week – Analyzing Mortgage Funds**

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### **Analyzing Mortgage Funds**

A few months ago, I introduced you to Mortgage Investment Corporations, or MICs. MICs are in the business of investing in mortgages. Shares issued by MICs are eligible investments for registered plans. MICs can distribute profits to shareholders without payment of corporate income tax. A few key restrictions placed on MICs are listed below:

- invest at least 50% of assets in residential mortgages;
- have a minimum of 20 shareholders, and no shareholder can own 25%+ of the total outstanding shares;
- all investments must be in Canada

The low interest rate environment in Canada has driven a lot of attention to MICs in the past few years. MICs are normally a low risk investment that provide annual dividends/yield to investors. Typically, low-risk profile MICs generate about 5% – 7% p.a., while medium to high risk profile MICs generate about 7% – 10% p.a. to investors in the current environment.

Since my last article on MICs, we have completed due diligence on three funds that invest in mortgages. The managers of the funds are - Bancorp Financial, Caplink Financial, and Tri City Mortgage. A lot of MICs do not charge any sales commissions, as investors purchase shares directly from the manager. The table below shows the cash flow of a typical MIC, assuming no sales commission, and that 100% of the capital raised is invested in mortgages.

<b>Capital Raised (gross)</b>	<b>\$100.00</b>
Sales Commission	\$0.00
Capital Deployed	\$100.00
<b>Interest Revenue (9% p.a.)</b>	<b>\$9.00</b>
Management Fee (2% p.a. of Investors' Capital)	-\$2.00
Other Expenses (0.5% of Capital Deployed)	-\$0.50
Provision for Loss (0.5% of Capital Deployed)	-\$0.50
<b>Net</b>	<b>\$6.00</b>
<i>Yield</i>	<i>6.00%</i>

The MIC in the above example lends capital at a 9% p.a., and returns 6% p.a. to investors.

The table below lists the key parameters of a MIC. When you analyze a MIC, ask the manager of the MIC the items listed under “Parameters”, and use the “Comments” to evaluate management’s response.

Parameters	Comments
Management Experience / Track Record	Analyze the manager's performance in the past 10 years. We have seen a 'boom' and 'bust' in that period, therefore, evaluating management's 10 year track record will give you a good understanding on their ability to perform in good and bad times.
Type of mortgages	Mortgages can be first, second, or lower tier – first mortgages are lower risk as they have the first claim on the collateral (property) in the event of a foreclosure.
Loan duration	Loan duration of MICs is typically 6 – 24 months – longer durations will have more exposure to real estate price fluctuations and interest rates.
Portfolio Diversification	A good MIC will have a diversified portfolio of mortgages across property type, region and borrower profile.
Deal flow	This is very crucial for a MIC, as timely deployment of capital is critical. As mortgages are short-term, a manager has to always source new loans or roll-over old loans to ensure cash is deployed all the time. This can be verified by checking the cash balance on the balance sheet at various times.
Average Loan to Value (LTV)	50% - 85%
Historic Default or Loan Loss Rate	The cash flow example above uses a 0.5% p.a. default rate – a higher rate default rate will eat into investors' returns.
Line of Credit (LOC)	It is normal for MICs to use LOC to bridge gaps between a new loan and an old loan. The LOC amount typically is below 25% of the total portfolio.
Expected return for investors	5% to 10% p.a., depending on the risk profile
Management Fee	1.0% - 2.5% p.a. – the fee can be tied to Net Asset Value (NAV), investors' capital, or investors' capital + LOC withdrawn; the best structure is to tie fees to NAV as NAV reflects the health / performance of a portfolio.
Loan origination fee	Managers typically charge a loan origination fee of 1% - 3% of the loan amount. Managers might either keep this amount for themselves or pass it on to the fund.
Operating Expenses	If managers keep the loan origination fee to themselves, it is reasonable for operating expenses of the fund to be 0.5% of the size of the portfolio. If the origination fee is passed on to the fund, operating expenses can be 2% - 2.5%.
Hurdle Rate	MICs tend to have a hurdle rate – all the returns up to the hurdle rate will be passed on to investors. Returns on top of the hurdle rate will be shared between investors and managers. Typical hurdle rate - floating (GOC + 4% - 7%) or fixed (6% to 8% p.a.). A floating structure is better as management might take on undue risks, in a low interest rate environment, if the hurdle rate is fixed.
Performance Share (on top of the hurdle rate)	80% to investors : 20% to manager
Redemption option	Unlike a lot of private company investments, most MICs offer redemption options – subject to certain penalties if redeemed prior to a lock-in period.

If you are interested in public MICs, a few names are - Trez Capital (TSX: TZZ), Atrium Mortgage (TSX: AI), First National Mortgage (TSX: FNM), Firm Capital Mortgage (TSX: FC), MCAN Mortgage (TSX: MKP), Timbercreek Mortgage (TSX: TMC) etc.



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### **Video Games**

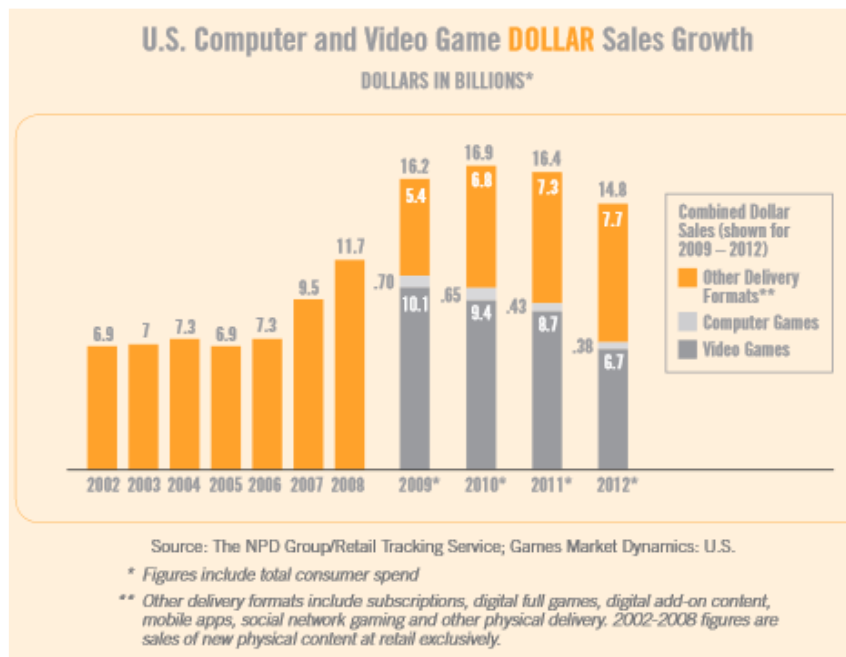
China has recently announced that it has plans to lift a 13 year old ban on the sale of gaming consoles in the country. The government said it would allow foreign companies that operate in the free trade zone the ability to sell gaming consoles throughout the country. The consoles and content would have to be approved by the ministry of culture first. This announcement offers significant opportunity for major console makers Microsoft (NASDAQ: MSFT), Sony (NYSE: SNE) and Nintendo (TOKYO: 7974) as well as video game makers.

In response to the new regulations, Microsoft last week announced it has formed a \$237 million USD joint venture with BES TV Media Co. a Chinese internet television company to work on programming and software. Nintendo plans to release a low cost console that targets the broad Chinese market. It will retail for the equivalent of \$60 USD.

The market opportunity of console gaming is unknown in China, with critics arguing that consoles have been available through the black market since the ban started and the adoption rate has been low. However, the price for black market consoles were high, and companies could not focus content to the Chinese market. The newer consoles also allow users to view media content and use the internet, which is attractive to Chinese consumers.

We looked at the console gaming market in the USA, and the Chinese computer gaming market, to give a rough indication to the possible market and growth for Chinese console gaming.

In the USA, it is estimated that 51% of households own at least 1 gaming console (source: ESA). Estimated revenue comparisons of video games (console games) and computer games by the Electronic Software Association (ESA) are shown below.

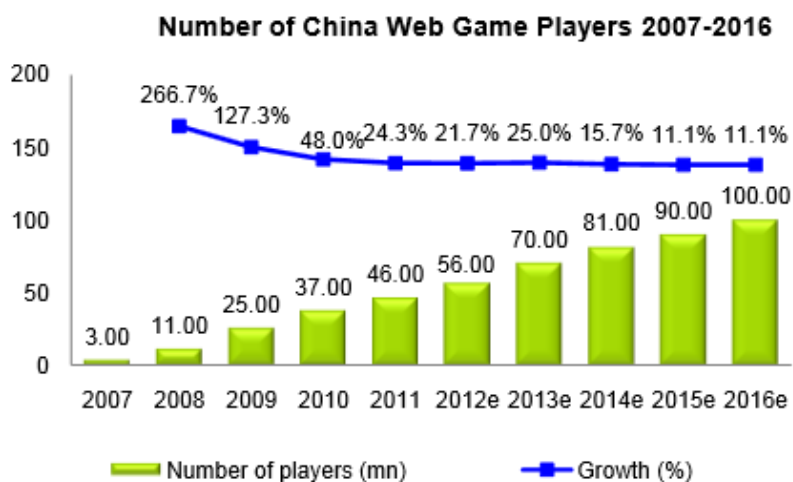


Iresearch China, a leading research firm focused on the internet industry in China has been tracking the rapid increase in computer gaming. They found a rapidly growing online gaming industry that produced \$43.38 billion Yuan of revenue in 2011 (exchange rate 6.12 Yuan to 1USD). This gives a rough indication to the possible market for Chinese console gamers.

The estimated value and growth of the massive multiplayer online games (Eg. World of Warcraft, StarCraft etc.) in China is shown below.



The number of Chinese Web based game players and the growth is shown below.



From the rough data discussed, we feel that there is the possibility for rapid growth in the Chinese video game console market. We will continue to follow these developments and look for investment opportunities as the ministry of Culture outlines what will be approved for consoles sales and content.

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