BEACON Securities Limited

The Westaim Corporation (WED-V)

Leveraging Insurance Expertise Into New Asset Manager Play

July 17, 2015

Michael Mills, CFA
(902) 425-8897
mmills@beaconsecurities.ca

- **We are assuming coverage of Westaim with a BUY rating and 12-month price target of $4.50.** The proven management team at Westaim has set a path to diversify operations beyond its current investment in privately-held insurance company HIIG. With the successful financing of a start-up asset management business (Arena and AFC), we believe growth is set to accelerate over the next couple of years.
- With a 44.3% look-through interest in HIIG, WED has benefited from growth at this specialty insurer. HIIG is run by an experienced management team, in what is a consolidating industry. **The HIIG investment, based on 1x book value, is significantly understated on WED's books, in our opinion.**
- **The Arena businesses will initially be 100% owned by WED, with management at Arena incentivized and aligned with WED shareholders to grow the business.** With existing relationships within the insurance world, we expect the credit investments pitched by Arena will find a wide audience. We think it is realistic to model Arena AUM approaching US$1 billion by the end of next year.
- **Management at WED is starting to build a financial services hub and we expect aggressive expansion over the next two years.** We believe investors should be getting into this name as it trades at book value, with surplus cash of ~$10 million, very experienced managers, and a track record of value creation.
- **We are in the early innings of the formation of a potential multi-billion dollar financial enterprise.** We believe there is strong upside in this name, with our $4.50 target based on 1.4x mid-2016 BV (vs. comps averaging 1.5x+).

Transfer of Coverage

BUY	$4.50
Previous Close	$3.20
12-month Target Price	$4.50
Potential Return	41%
52 Week Price Range	$2.54-$3.63
Yield	0.0%

Estimates

YE: Dec 31	FY14A	FY15E	FY16E
Shareholders Equity	$194.0	$446.1	$498.0
BVPS (incl RSUs)	$2.71	$3.10	$3.45

Valuation

	FY14A	FY15E	FY16E
Price/BV	1.18x	1.03x	0.93x

Stock Data (MM except per share items)

Shares Outstanding		
FD	143.2	(after escrow release)
Market Cap		
FD	$458.2	
Net Cash	$9.0	(post Arena start-up)
EV	$449.2	

About the Company

Westaim is a Canadian investment company seeking to grow by providing capital and strategic expertise to businesses in the financial services industry. The company is headquartered in Toronto. www.westaim.com

All prices in CAD$ unless otherwise stated

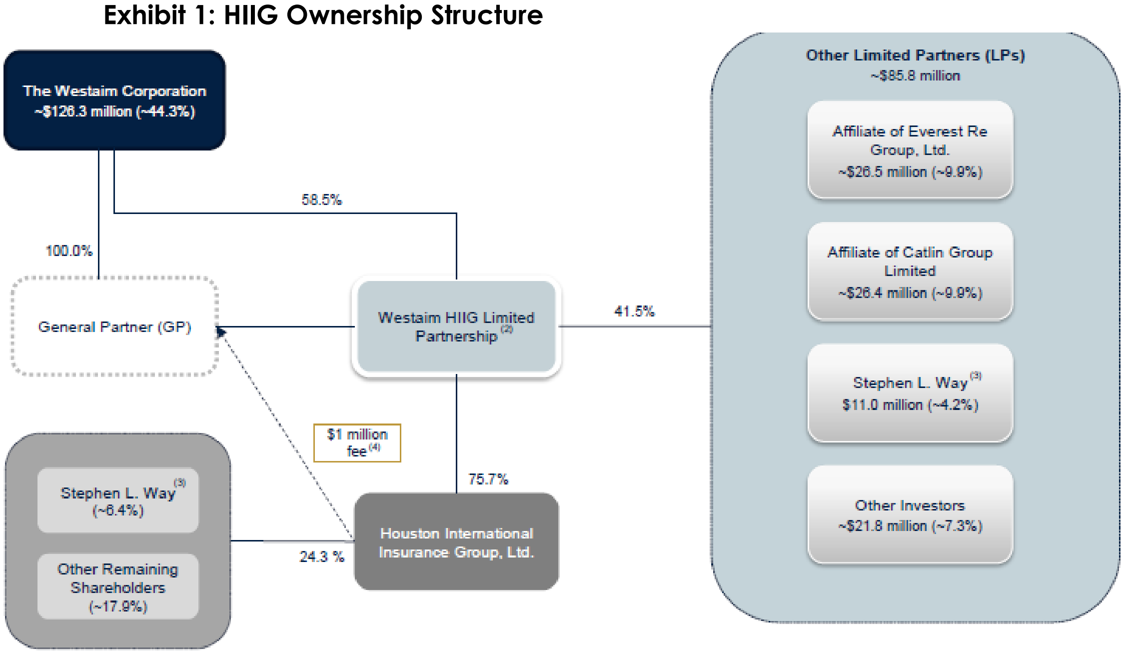
Stock Performance

Building a Strong Financial Services Hub

Management at Westaim, led by Cameron MacDonald (President and CEO) and Robert Kittel (COO), have adeptly leveraged their past investment success in insurance (Jevco investment roughly doubled in 22 months) into a significant shareholding in Houston International Insurance Group (HIIG). WED is part of an ownership group in Westaim HIIG Limited Partnership that owns 75.7% of privately-held HIIG. WED controls 58.9% of the Partnership, or look-through ownership of 44.6% in HIIG. Ultimately, this percentage ownership from both the Partnership and WED perspectives could continue to increase. Westaim receives an annual US$1 million fee from HIIG for advisory services (to 2017) and US$0.5 million annually for the two following years.

Other significant shareholders in the Partnership include insurance heavyweights Catlin Group (being purchased by XL Group; XL-NYSE, not rated) and Everest Re Group (RE-NYSE, not rated). Each has a ~9.9% look through ownership interest in HIIG. The glue behind this Partnership is HIIG's President and CEO, Stephen Way. Starting HIIG after a hugely successful term founding and leading another specialty insurer (HCC; recently bought by Tokio Marine for US$7.5 billion), Mr. Way brought in new investors led by WED and has put $11 million of his own money into the Partnership (which is in addition to his existing holdings in HIIG).

Exhibit 1: HIIG Ownership Structure



Figures in US $
(1) As at March 31, 2015. Numbers represent total contribution to the Partnership; Percentages in brackets represent economic look-through interest in HIIG
(2) Limited Partnership established by Westaim to acquire an ownership interest in HIIG
(3) Includes investment by family members, and through family trusts associated with Stephen L. Way
(4) $1 million per annum for the first three years and $0.5 million per annum for the next two years

Source: Company presentation

Michael Mills | 902.425.8897 | mmills@beaconsecurities.ca

HIIG is a fast growing specialty insurance company, including the recent acquisition of Elite Underwriting Services. We expect HIIG to continue to pursue growth with the acquisition of insurance underwriters; known as MGUs or MGAs. This could require additional equity to be raised by the Partnership and ultimately at the WED level. Westaim was able to invest initially in HIIG at a discount to book value, but we would expect future investments to be made at book value (just as it was with the January 2015 investment). We believe this is still an attractive valuation level considering specialty insurance companies generally trade at a sizeable premium to book value in the market (see more detail in our valuation section). We think eventually HIIG could go public, providing either an exit or at a minimum a daily market valuation for WED's investment.

Adding Arena To The Portfolio

In early May, Westaim announced an equity financing to launch and fund two new investment management companies. Gross proceeds of ~$237 million were raised by issuing special warrants at a price of $3.25 apiece. This included $24.7 million subscribed by insiders.

The two newly formed companies, initially 100% owned by Westaim, are Arena Finance Company (AFC) and Arena Investors LLC (Arena). Both are expected to formally launch in Q3 2015. AFC will be a specialty finance company focused on fundamentals-based asset-oriented credit opportunities. Westaim plans to capitalize AFC with approximately US$200 million from the equity raise. In addition, WED has agreed to fund start-up costs (6-12 months) up to US$4.3 million for Arena and AFC. Arena will act as a global asset manager for third parties seeking investment opportunities delivering attractive yields with low volatility. Arena will collect both management fees and performance fees. Both AFC and Arena will be led by CEO Daniel Zwirn. As part of the transaction, Mr. Zwirn has purchased $2.5 million of WED stock in the financing. Completion of Arena transactions is currently targeted for August 2015.

Over time, Mr. Zwirn and other key employees of Arena are entitled to earn up to 75% common share ownership in Arena. The earn-in is based on assets under management and EBITDA profitability levels. The initial 49% of common share ownership is to be achieved once Arena's AUM reaches US$1 billion and TTM EBITDA margin reaches 35% (initial threshold). The full 75% ownership will be reached when Arena's AUM reaches US$5 billion and its TTM EBITDA margin reaches or exceeds 60%. Upon commencement of operations, Arena management will have a 49% claim to the after-tax cash flows of Arena (and growing with ownership stake after initial threshold reached). It is expected that Arena management will commit to invest 50% of the first US$50 million (25% thereafter) of after-tax cash distributions in purchasing Westaim shares in

Michael Mills | 902.425.8897 | mmills@beaconsecurities.ca

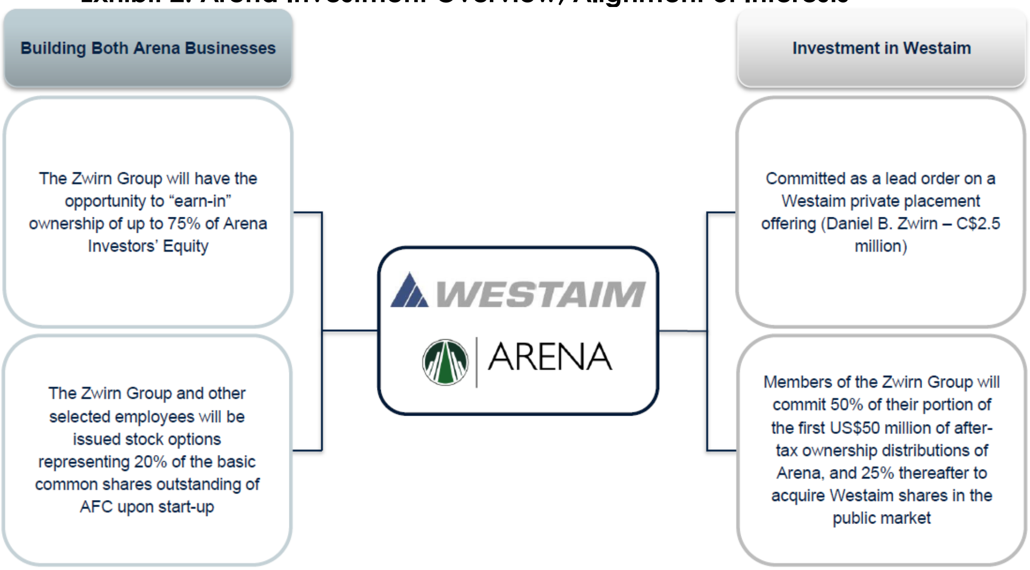
the open market at the prevailing share price (to maximum ownership of 19.9%). We expect this will help support the Westaim share price for the next few years.

Ownership of AFC will see Westaim purchase US$200 million of common shares of AFC from treasury at $10.00 per share (for 100% ownership initially). AFC will issue different tranches of options, representing 20% of basic common shares, to Arena management. Each tranche will vest equally on the first, second, third, fourth and fifth anniversary of closing. The different tranches are:

- Tranche A: 5% (1,000,000 options) at strike price of US$10.00 per share;
- Tranche B: 5% (1,000,000 options) at strike price of US$12.50 per share;
- Tranche C: 5% (1,000,000 options) at strike price of US$15.00 per share;
- Tranche D: 5% (1,000,000 options) at strike price of US$17.50 per share.

Arena Leadership: Mr. Zwirn is a Harvard MBA graduate and was a Managing Partner and Chief Investment Officer of D.B. Zwirn & Co (DBZ). He and his company have structured and managed over US$10 billion in special situation financing and asset-oriented investments. DBZ was founded in 2001. In late October 2006, DBZ voluntarily self-reported issues related to management fee billings and loans related to an aircraft purchase to the Securities and Exchange Commission ("SEC"), which commenced a formal investigation. Auditors eventually issued a clean audit report and no restatement was required. In January 2008, DBZ elected to put its funds in an orderly liquidation and Mr. Zwirn was no longer in control of capital allocation. After an exhaustive investigation, the SEC issued letters of termination to Mr. Zwirn (Feb 2011) and DBZ (April 2011) indicating that the SEC would not take further action.

Exhibit 2: Arena Investment Overview, Alignment of Interests



Source: Company presentation

Michael Mills | 902.425.8897 | mmills@beaconsecurities.ca

Key Model Assumptions

Prior to the Arena deal, Westaim was a fairly straight-forward story as the only asset was its ownership stake in HIIG. The value of this asset changes due to four factors: profitability, unrealized gains on investments, foreign exchange variability (as HIIG assets are USD denominated and WED reports in CAD), and the valuation multiple applied to book value (WED uses 1x). We assume very modest BV increases over our forecast period from HIIG profits, and are wary of a rising interest rate environment and the negative impact that this can have on book value.

The addition of Arena requires assumptions to be made about the growth in AUM and the returns that can be generated. We understand that Arena is targeting unlevered returns of 12%-13%. Assuming some leverage is employed (0.5x-1x) could see returns in the high teens. This is before fees, which we assume will be the typical 2/20 model (2% management fee and 20% performance fee) charged to third party investors. We believe that in the low return environment that we continue to live in, insurance companies are seeking higher yield debt instruments with floating rate structures to bolster investment returns.

We would expect that HIIG will be an early participant in the Arena product pool. We estimate that HIIG could contribute US$50 million within the first year to Arena, representing less than 8% of its investable assets (US$680 million as of the end of March). In addition, Mr. Zwirn and friends and family are expected to invest ~US$15 million through Lantern Endowment Partners LP.

We expect that Arena will attract assets from global insurance companies seeking alternative credit-oriented investments. The major insurance players carry investment books worth tens of billions, and we believe that gaining only a very small percentage of these assets would translate into hundreds of millions worth of AUM for Arena. Therefore, given the already entrenched relationships in the industry, we believe it is reasonable to model Arena with AUM of US$1 billion by the end of 2016.

There are two separate businesses to model. Arena, the third party asset manager generating fees based on a growing AUM base, and AFC generating returns (growing BV) with an assumed starting base of US$200 million (C$250 million) investment from Westaim. Below, in exhibit 3, is an example based on third party AUM of US$1 billion at the end of 2016. Note that below US$1 billion in AUM, WED maintains 100% ownership but does split cash flows 51%/49%.

Exhibit 3: Arena Third Party Management Economics (F2017 Example)

Arena third party managed AUM	**US$1 billion**
Leverage 50%	US$500 million
Total Assets	US$1.5 billion
2% equity management fee	US$20 million
Assumed **levered** investment return	18% or US$180 million
20% performance fee earned by Arena (post 2% mgmt. fee and 3% debt cost)	US$29 million
Total fees earned	**US$49 million**
Assumed 35% EBITDA margin	US$17.15 million
WED rights to 51% of EBITDA	**US$8.75 million**
Mr. Zwirn & Co rights to 49% of EBITDA	US$8.4 million

Source: Beacon Securities

In addition, there is the US$200 million being invested through AFC where by WED initially has 100% ownership. If we assume the same financial returns (12%, unlevered), this would be an additional US$24 million in equity value in year one, prior to accounting for costs within AFC. The actual contribution is likely to be higher by 2017 as gains are reinvested (AUM grows) from the late 2015 start.

Therefore, between these two business lines, it is possible to see EBITDA generation of US$30+ million in 2017. Of course everything is dependent on the actual realized investment returns and there is no doubt these returns will be lumpy. However, Mr. Zwirn has a track record of success and is in tune with the opportunities within the credit market to achieve above average returns in this low rate environment. We note that changing our unlevered return assumption to 6% (from 12%), would equate to WED EBITDA of ~US$17.5 million from the above two business lines.

We think starting Arena from scratch, with raised seed money and existing relationships with potential insurance clients, was a smart way to enter the asset management business. It removed the risk of overpaying for goodwill associated with an existing business/partner. Ultimately, time will tell how much value Arena surfaces (we think a lot), but at this point it provides a relatively low risk call option on the asset management business. We believe Mr. Zwirn, who is just 44 years old, is appropriately incentivized and motivated to grow Arena in the coming years.

The addition of Arena to the WED mix provides significant growth leverage to this story. Ultimately, Arena will succeed or fail under the guidance of a proven asset manager in Mr. Zwirn. We think Arena is just one of the stepping stones that will be put in place as the management team at Westaim build out a large financial services hub model.

Michael Mills | 902.425.8897 | mmills@beaconsecurities.ca

Valuation and Recommendation

We are assuming coverage of Westaim with a 12-month price target of $4.50 and a BUY rating. We use a 1.4x multiple against our mid-2016 book value estimate of $3.24 to reach our target price. As of the end of March (last reported period), WED carried a BV of $2.95 per share. We note there is the potential for valuation multiple expansion as the asset management business gets proven out. The insurance comps trade at a median BV multiple of 1.5x 2015, while the asset managers are at 1.9x. For example, using 1.6x our YE 2016 book value of $3.45 would support a target of $5.53. See comparable valuation tables in the appendix to this report.

Post the investment in Arena, we expect Westaim to have ~$10 million in cash and no debt. We believe management is already looking for its next investment and we would not be surprised to see further equity raised to fund the building of a diversified financial services hub under the Westaim umbrella. With a proven management team, strong capital structure, and attractive valuation, we see WED as a compelling investment at current levels.

Recent Insurance Sector M&A Provides Valuation Support

As the table below demonstrates, there have been several high profile deals in the insurance/reinsurance industry so far in 2015. The deal of most interest to the WED story is the take-over of HCC by Tokio Marine. HCC was founded by Stephen Way (current CEO at HIIG), where he remained Chairman until 2007. Under his tenure the asset base at HCC grew at a CAGR of 29%. The 1.9x book value take-out offer demonstrates the value being placed on specialty insurance firms.

Exhibit 4: Insurance Industry M&A Activity in 2015

Acquirer	Acquiree	Deal Value (USD)	Price to BV
Tokio Marine	HCC	$7.5	1.9x
ACE	Chubb	$28.3	1.8x
XL	Catlin	$4.2	1.2x

Source: Company reports, Beacon Securities

Michael Mills | 902.425.8897 | mmills@beaconsecurities.ca

Key Risks

Executing and Managing Growth: The latest Arena business has yet to begin formal operations and modeling requires significant assumptions around the pace of asset gathering and investment returns. We expect management to pursue other investments within the financial services sector and the integration of these assets is unknown.

Key Person Risk: We attribute considerable value to Westaim's management team, the leadership at HIIG and Arena, and Board of Directors.

Insurance Pricing and Catastrophic Events: Insurance is a highly competitive business and pricing is market driven. Premium pricing softness can impact on growth trends. P&C insurers are subject to claims arising from catastrophes. Catastrophic events can create significant losses.

Foreign Exchange: With US based operations, Westaim is subject to currency fluctuations, particularly related to the fair value accounting of the investments in HIIG and Arena.

Michael Mills | 902.425.8897 | mmills@beaconsecurities.ca

Appendix – Comp Valuation

Insurance Comparables

						BVPS		P/B	
Company	Ticker	Last Price	Market Capitalization (MM)	Dividend	Dividend Yield	2015E	2016E	2015E	2016E
Westaim Corporation	**WED-CA**	**$3.20**	**$458**	**$0.00**	**0.0%**	**$3.10**	**$3.45**	**1.0x**	**0.9x**
ACE Limited	ACE-USA	$104.36	$33,781	$2.58	2.5%	$93.39	$99.24	1.1x	1.1x
Allstate Corporation	ALL-USA	$67.98	$27,805	$0.00	0.0%	$51.14	$54.79	1.3x	1.2x
American International Group, Inc.	AIG-USA	$64.16	$85,551	$0.50	0.8%	$83.92	$90.98	0.8x	0.7x
AMERISAFE, Inc.	AMSF-USA	$48.98	$930	$0.48	1.0%	$25.99	$28.25	1.9x	1.7x
AmTrust Financial Services Inc.	AFSI-USA	$66.38	$5,483	$0.85	1.3%	$26.78	$31.40	2.5x	2.1x
Chubb Corporation	CB-USA	$121.95	$27,755	$2.00	1.6%	$72.19	$76.24	1.7x	1.6x
HCC Insurance Holdings, Inc.	HCC-USA	$77.44	$7,407	$1.04	1.3%	$43.22	$46.08	1.8x	1.7x
Intact Financial Corporation	IFC-TSE	$91.65	$12,056	$1.92	2.1%	$42.20	$46.80	2.2x	2.0x
Markel Corporation	MKL-USA	$876.43	$12,223	$0.00	0.0%	$594.08	$633.04	1.5x	1.4x
Navigators Group, Inc.	NAVG-USA	$78.98	$1,137	$0.00	0.0%	$77.53	$83.34	1.0x	0.9x
RLI Corp.	RLI-USA	$53.38	$2,305	$0.71	1.3%	$18.93	$19.04	2.8x	2.8x
Travelers Companies, Inc.	TRV-USA	$103.29	$32,918	$2.15	2.1%	$80.34	$85.38	1.3x	1.2x
W. R. Berkley Corporation	WRB-USA	$56.23	$7,020	$0.43	0.8%	$37.71	$40.53	1.5x	1.4x
XL Group Plc	XL-USA	$38.24	$11,726	$0.64	1.7%	$40.30	$43.38	0.9x	0.9x
Peer Average								**1.6x**	**1.5x**
Peer Median								**1.5x**	**1.4x**

Source: Factset, Beacon Research
Red denotes subject of take-over agreement

Cdn Listed Asset Manager Comparables

						BVPS		P/B	
Company	Ticker	Last Price	Market Capitalization (MM)	Dividend	Dividend Yield	2015E	2016E	2015E	2016E
Westaim Corporation	**WED-CA**	**$3.20**	**$458**	**$0.00**	**0.0%**	**$3.10**	**$3.45**	**1.0x**	**0.9x**
AGF Management Limited Class B	AGF.B-CAN	$6.06	$504	$1.08	17.8%	$11.25	$11.68	0.5x	0.5x
Aston Hill Financial Inc.	AHF-CAN	$0.45	$40	$0.00	0.0%	$0.36	$0.33	1.3x	1.4x
CI Financial Corp.	CIX-CAN	$34.02	$9,517	$1.19	3.5%	$7.41	$8.48	4.6x	4.0x
Fiera Capital Corporation Class A	FSZ-CAN	$12.51	$612	$0.46	3.7%	$6.47	$6.58	1.9x	1.9x
Gluskin Sheff + Associates Inc	GS-CAN	$24.17	$766	$3.58	14.8%	$3.78	$4.11	6.4x	5.9x
IGM Financial Inc.	IGM-CAN	$40.11	$9,966	$2.18	5.4%	$19.48	$20.55	2.1x	2.0x
Guardian Capital Group Limited Cl	GCG.A-CAN	$19.10	$516	$0.24	1.3%	$15.57	$16.59	1.2x	1.2x
Peer Average								**2.6x**	**2.4x**
Peer Median								**1.9x**	**1.9x**

Michael Mills | 902.425.8897 | mmills@beaconsecurities.ca

Disclosure Requirements

Does Beacon, or its affiliates or analysts collectively, beneficially own 1% or more of any class of the issuer's equity securities? ☐ Yes ☒ No

Does the analyst who prepared this research report have a position, either long or short, in any of the issuer's securities? ☐ Yes ☒ No

Does Beacon Securities beneficially own more than 1% of equity securities of the issuer? ☐ Yes ☒ No

Has any director, partner, or officer of Beacon Securities, or the analyst involved in the preparation of the research report, received remuneration for any services provided to the securities issuer during the preceding 12 months?
☐ Yes ☒ No

Has Beacon Securities performed investment banking services in the past 12 months and received compensation for investment banking services for this issuer in the past 12 months? ☐ Yes ☒ No

Was the analyst who prepared this research report compensated from revenues generated solely by the Beacon Securities Investment Banking Department? ☐ Yes ☒ No

Does any director, officer, or employee of Beacon Securities serve as a director, officer, or in any advisory capacity to the issuer? ☐ Yes ☒ No

Are there any material conflicts of interest with Beacon Securities or the analyst who prepared the report and the issuer? ☐ Yes ☒ No

Is Beacon Securities a market maker in the equity of the issuer? ☐ Yes ☒ No

Has the analyst visited the head office of the issuer and viewed its operations in a limited context? ☒ Yes ☐ No

Did the issuer pay for or reimburse the analyst for the travel expenses? ☐ Yes ☒ No

All information contained herein has been collected and compiled by Beacon Securities Limited, an independently owned and operated member of the Investment Industry Regulatory Organization of Canada (IIROC). All facts and statistical data have been obtained or ascertained from sources, which we believe to be reliable, but are not warranted as accurate or complete.

All projections and estimates are the expressed opinion of Beacon Securities Limited, and are subject to change without notice. Beacon Securities Limited takes no responsibility for any errors or omissions contained herein, and accepts no legal responsibility from any losses resulting from investment decisions based on the content of this report.

This report is provided for informational purposes only and does not constitute an offer or solicitation to buy or sell securities discussed herein. Based on their volatility, income structure, or eligibility for sale, the securities mentioned herein may not be suitable or available for all investors in all countries.

As at June 30, 2015	#Stocks	Distribution
Buy	50	65.7%
Speculative Buy	14	20.9%
Hold	3	4.5%
Sell	0	0.0%
Under Review	5	9.0%
Total	72	100.0%

Buy	Total 12-month return expected to be > 15%
Speculative Buy	Potential 12-month return is high (>15%) but given elevated risk, investment could result in a material loss
Hold	Total 12-month return is expected to be between 0% and 15%
Sell	Total 12-month return is expected to be negative
Under Review	Currently undergoing a change of analyst coverage

Dissemination
Beacon Securities distributes its research products simultaneously, via email, to its authorized client base. All research is then available on www.beaconsecurities.ca via login and password.

Analyst Certification
The Beacon Securities Analyst named on the report hereby certifies that the recommendations and/or opinions expressed herein accurately reflect such research analyst's personal views about the company and securities that are the subject of the report; or any other companies mentioned in the report that are also covered by the named analyst. In addition, no part of the research analyst's compensation is, or will be, directly or indirectly, related to the specific recommendations or views expressed by such research analyst in this report.