

Business Update Call

Company Participants

- Derek Bulas, AVP - Legal
- Vivian Prem Watsa, Chairman & Chief Executive Officer

Other Participants

- Jeffrey Fenwick, Analyst
- Jonathan Aaron Chin, Portfolio Manager
- Tom MacKinnon, Analyst

MANAGEMENT DISCUSSION SECTION

Operator

Good morning, and welcome to Fairfax Investor Conference Call. Your lines have been placed in a listen-only mode. After the presentation, we will conduct a question-and-answer session. Today's conference is being recorded. If you have any objections, you may disconnect at this time. Your host for today's call is Prem Watsa, with opening remarks from Mr. Derek Bulas. Mr. Bulas, please begin.

Derek Bulas

Good morning, and welcome to our call to discuss Fairfax's transactions with MSI. This call may include forward-looking statements. Actual results may differ perhaps materially from those contained in such forward-looking statements as a result of a variety of uncertainties and risk factors. The most foreseeable of which are set out under Risk Factors in our Base Shelf Prospectus, which has been filed with Canadian Securities regulators and is available on SEDAR.

I'll now turn the call over to our Chairman and CEO, Prem Watsa.

Vivian Prem Watsa {BIO 16700363 <GO>}

Thank you, Derek. Good morning, ladies and gentlemen, and a warm welcome to all of the Fairfax shareholders on this call. This is a very big day for everyone involved with Fairfax. Let me start by saying we are extremely excited about entering into a binding partnership with Mitsui Sumitomo Insurance or MSI based in Tokyo, Japan. This partnership is highly significant both for Fairfax and for MSI, and we think it will be very beneficial for both the shareholders of Fairfax and MSI over the long-term.

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We invite you to read our press release from last night, as well as the presentations that I included. I will refer to both these press release and the presentation throughout the course of this call. MSI, as you know, is a global life and non-life insurer with over a 300-year history in the business. They know long-term. I have personally met with the leadership of MSI, and I can say our cultures are very similar as to the long-term vision and values, and to our focus on customers, employees, shareholders and communities. We are both focused on the long-term and on treating people well.

Our businesses are also very complementary across the globe, as you can see on page 3 of the presentation. MSI is the largest non-life insurer in Japan with approximately \$25 billion in non-life premium in Japan, and a 33% market share.

See page 4 of the presentation for additional details on MSI. The broad strokes of the transaction are summarized on page 1 of the presentation. Fairfax and MSI have agreed to enter into a cooperation agreement with the view to looking at mutual beneficial opportunities to work together, globally, in areas such as sharing of opportunities on reinsurance fees (03:22) in the United States, Asia and elsewhere; collaborating with us on our respective Lloyd's businesses; providing our specialty lines expertise, for example, our workers compensation expertise, for MSI's Japanese clients in the United States.

Fairfax will have the opportunity to participate by way of a quota share in MSI's net account of domestic Japanese business, and MSI will have a similar opportunity with our global business. The details of these cooperative partnership arrangements will be fleshed out in a definitive cooperation agreement in the coming weeks.

To facilitate this partnership, Fairfax will sell its 97.7% interest in First Capital to MSI, while retaining a meaningful 25% quota share participation in First Capital's existing and future business. We fully expect that with MSI's backing and Mr. Athappan's expertise, First Capital will grow from approximately \$400 million in gross premium written today to over \$1 billion in gross premium written over time. The 97.7% interest in First Capital has been sold to MSI for \$1.6 billion. This sale represents a net after tax gain to Fairfax of approximately \$900 million or approximately \$33 per share. Fairfax will indemnify MSI for any shortfall in the year end 2016 loss reserves of First Capital, as well as any shortfall in the 2016 book value of First Capital of approximately \$484 million. We expect our results to be strong and see no liabilities from these guarantees.

MSI is purchasing the largest property and casualty insurer in Singapore, First Capital. First Capital was effectively founded by Mr. Athappan, and had been nurtured and grown by him since Fairfax's initial investment in the company in 2002. Fairfax initially invested \$35 million, and with Mr. Athappan's unparalleled expertise and reputation, he has grown the business, without any additional capital from Fairfax, to be the undisputed leader in Singapore with a combined ratio under 72% over that 15-year period.

Under our partnership arrangement with MSI, Mr. Athappan is returning approximately \$1.6 billion in capital to Fairfax. That is a compound growth rate of 29% annually for 15 years. And by the way, that is with very little help from the investing side. I'm sure you will agree, an extraordinary performance by Mr. Athappan with more to come.

Mr. Athappan championed this partnership with MSI as he believes the combination creates a win-win by allowing Fairfax to continue to have a meaningful 25% participation in the existing and ongoing First Capital business, which will grow under Mr. Athappan's continued leadership with the assistance of MSI's greater presence and strength in Asia, while also providing meaningful opportunities for the business of the broader Fairfax group to expand through partnership opportunities with MSI.

With MSI's backing in the business at First Capital, we'll continue to grow, and so too the number of employees and opportunities at First Capital. As Mr. Athappan said in our press release, this wonderful new partnership creates a win-win-win by providing a runway for growth of the company. He says, I helped nurture and grow this company, while also significantly growing the business of both Fairfax Asia and the Fairfax group. In the spirit of partnership, Mr. Athappan has committed to continue as CEO of First Capital under MSI's ownership, while retaining his responsibilities as Chairman of Fairfax Asia in the Fairfax group.

Both Mitsui and Fairfax are excited that Mr. Athappan will continue to run both companies as he has done for the past 15 years.

So you can see this partnership with MSI is truly a game changer for Fairfax, a real win-win opportunity with a long-term, like-minded partner. An added benefit of this transaction for Fairfax will be that some of the gross proceeds of the \$1.6 billion will be available to repurchase our stock at these prices. We are so thankful for the opportunities and potential which have presented themselves to us over our 32-year history. Fairfax's team-oriented culture and fair and friendly reputation have resulted in many transformative transactions and partnerships. And while we cannot predict the timing, we expect to have many more in the future as we grow our business and reputation globally.

So with that, Bob, I wanted to open up the call for questions, and we'll be happy to answer any that you may have.

Q&A

Operator

Thank you, Mr. Watsa. We have our first line in queue from Jeff Fenwick of Cormark Securities. Jeff, your line is now open.

Q - Jeffrey Fenwick

Hi, good morning, everyone.

A - Vivian Prem Watsa {BIO 16700363 <GO>}

Good morning.

Q - Jeffrey Fenwick

So, Prem, this is obviously a very big transaction for Fairfax, so I wanted to ask around that decision to sell. I mean, historically, you've been very clear around the Fairfax approach of never selling any of its owned insurance businesses. So, was this just – something that was just so exceptional around this transaction that you're willing to do this, and does this change your view with respect to the other companies within the Fairfax group?

A - Vivian Prem Watsa {BIO 16700363 <GO>}

No. Jeff, this is a very good question, and I addressed this with all our presidents and our employees in the last few days. We are selling First Capital under very unusual and exceptional circumstances. As I've said in the call earlier, Mr. Athappan strongly championed this partnership with MSI because, for three reasons. One, it provides Fairfax with a global alliance with a world-leading company, MSI, with a similar culture and values like us. It gets us into Japan and helps MSI expand as our partner into areas where we have the expertise.

Two, we participate through a significant 25% quota share in First Capital's existing and future business, which will be won by Mr. Athappan. And three, and perhaps most importantly and key, is the fact that Mr. Athappan will continue to run both First Capital and Fairfax Asia.

It is extraordinary that both Mitsui and Fairfax felt comfortable that Mr. Athappan could run both companies as he has done for the last 15 years. It's in this perspective that we decided in the spirit of this global partnership with MSI to listen to Mr. Athappan and sell First Capital to them. I want to emphasize that these are extremely exceptional circumstances that we do not expect to be repeated in the future. So, our view is very clearly that our companies will continue not to be for sale. These are exceptional circumstances, and that's why it happened the way I've just described it.

Jeff, a follow-up question, if you have one?

Operator

Thank you, Jeff. Sir, our next question is from Jonathan Chin of Private Management Group. Jonathan, your line is open.

Q - Jonathan Aaron Chin {BIO 20156882 <GO>}

Thanks for taking the question. I was curious – what incurred but not reported lines you would be looking out for if there were to be positive or unfavorable development on the lines that you guys are reinsuring? Thank you.

A - Vivian Prem Watsa {BIO 16700363 <GO>}

Yeah. You mean on First Capital, Jonathan?

Q - Jonathan Aaron Chin {BIO 20156882 <GO>}

Yes.

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A - Vivian Prem Watsa {BIO 16700363 <GO>}

So we've guaranteed the reserves, if that's what you're saying, and the history of First Capital over 15 years is reserve redundancies. So we see almost no possibility that the reserves will not be redundant in the years to come. Thank you, Jonathan.

Q - Jonathan Aaron Chin {BIO 20156882 <GO>}

Thank you.

A - Vivian Prem Watsa {BIO 16700363 <GO>}

Next question, Bob?

Operator

Sir, our next question is from Tom MacKinnon of BMO. Tom, your line is open.

Q - Tom MacKinnon {BIO 2430137 <GO>}

Yeah. Thanks very much. Two questions, if I may. The first is with respect to the quota share. So I assume you get proceeds from the sale, but then you're going to have to reinvest into First Capital in order to take a 25% quota share reinsurance arrangement.

A - Vivian Prem Watsa {BIO 16700363 <GO>}

No, that's not how it works, Tom.

Q - Tom MacKinnon {BIO 2430137 <GO>}

Okay.

A - Vivian Prem Watsa {BIO 16700363 <GO>}

So what happens is if First Capital writes \$100 million worth of business, we'll take a quota share of 25%, which will be, say, \$25 million, and that \$25 million will be going into one of our companies. It will go from First Capital to one of our companies. It could go into Wentworth, it could go into any of our companies that we will figure out over time as to where we want to put it. So that's how quota shares work. So it's not like we have to put more money into First Capital.

Q - Tom MacKinnon {BIO 2430137 <GO>}

But you said it was on the existing business as well. Is there any - are you taking then - of all the claims liabilities associated with the existing business, you're going to be taking 25%? Are you going to be paying 25% of those claims?

A - Vivian Prem Watsa {BIO 16700363 <GO>}

No, so the (13:48)

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Q - Tom MacKinnon {BIO 2430137 <GO>}

You talked about the ongoing (13:50), but you also said it was with existing businesses...

A - Vivian Prem Watsa {BIO 16700363 <GO>}

...\$100 million of existing business, and say it becomes \$200 million, just to make the math easy. And so we'll get 25% of the \$200 million, depends on - it will be a net quota share. But just for the easy math, so we'll get 25% of the \$200 million, that's about \$50 million. And that \$50 million will be like a reinsurer, it will take the money from the First Capital and it'll go into one of our companies.

Q - Tom MacKinnon {BIO 2430137 <GO>}

So we should think that we're probably going to still get 25% of the First Capital kind of earnings that you were getting going forward, is that the way we should look at it? But...

A - Vivian Prem Watsa {BIO 16700363 <GO>}

That's how you should think about it.

Q - Tom MacKinnon {BIO 2430137 <GO>}

Okay.

A - Vivian Prem Watsa {BIO 16700363 <GO>}

You should think about, we'll get 25% of the earnings and you'll get 25% of the growth.

Q - Tom MacKinnon {BIO 2430137 <GO>}

Yeah.

A - Vivian Prem Watsa {BIO 16700363 <GO>}

That made it a very unusual and attractive transaction.

Q - Tom MacKinnon {BIO 2430137 <GO>}

And presumably, the subsidiaries of Fairfax for this business will go to - would have to have capital adequate to be able to support that additional level of premiums written. And I assume they do have...

A - Vivian Prem Watsa {BIO 16700363 <GO>}

That's very true. Whichever company we put it into, Tom, will have to have the capital to support that, yeah. But we've got excess capital throughout our system that we can take that business.

Q - Tom MacKinnon {BIO 2430137 <GO>}

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And then in terms of the net proceeds that you're getting from this, you talked about repurchasing stock at these prices. What about the additional investors that helped up with Allied World, is that another potential avenue that you would go to, is bringing in their share of Allied World?

A - Vivian Prem Watsa {BIO 16700363 <GO>}

About our other investors, we've just closed that so we'll have to wait some time before we can buy them out. And they have to make a return before we are able to buy them out. But certainly, that's one of the possibilities. But the one that's staring us right in the face is Fairfax's stock price. We reduced our interest in ICICI Lombard. We've talked about that before, that hasn't flown into our income statement yet. And if you figure it out, that's at least about \$700 million and perhaps more. There's an IPO that's about to take place. We've sold 10% or 12%, I think it was. We're selling another 12%, and then we'll have a 10% position, which will perhaps be valued at a higher price.

And if you add all of that, that's through (16:42) \$700 million. And that was hardly on our balance sheet. There was hardly any value there on our balance sheet. So all of this shows you that Fairfax - and this is what I've been emphasizing in our annual reports. The intrinsic value of Fairfax is significantly higher. And so this was another transaction that I think - and it's in the form of a partnership which we think has huge potential, as I mentioned in the call earlier, in our script. But also in terms of realizing very significant gains and very significant cash. And we think the first use of that will be for our stock.

Operator

Thank you, Tom. Mr. Watsa, we have our next question, it's from Junior Ra (17:38), a private investor. Junior (17:42), your line is open.

A - Vivian Prem Watsa {BIO 16700363 <GO>}

Good morning, Junior (17:45).

Operator

Hi, Junior (17:52), I think you're on mute.

A - Vivian Prem Watsa {BIO 16700363 <GO>}

Hey, guys, I don't think Junior (17:57) is there.

Q - Operator

Sorry, sorry. I was on mute. Congratulations, and good morning. Hello, can you guys hear me?

Yes, sir. Go ahead.

A - Vivian Prem Watsa {BIO 16700363 <GO>}

Good morning, Junior (18:08).

Q - Operator

Yeah. When can we expect this on our books, is it Q4 or Q1 of next year?

A - Vivian Prem Watsa {BIO 16700363 <GO>}

Yeah. What can we expect what, Junior (18:17)?

Q - Operator

The actual - the capital gains to be reported.

A - Vivian Prem Watsa {BIO 16700363 <GO>}

Yeah. Like we told you, the - on this one, it's \$900 million of after tax capital gain approximately, plus, minus, and that's been shown. And the other, Junior (18:38), will be the ICICI Lombard. But anything else after that will be - we don't comment on that. That's as and when markets will just develop and we'll report.

Q - Operator

But is the \$900 million going to be reported in Q4 or Q1 of next year, or is that going to be reported earlier?

A - Vivian Prem Watsa {BIO 16700363 <GO>}

If it closes in Q4, it will be reported in Q4; if it closes in first quarter, it will be reported in the first quarter. Whenever it closes.

Q - Operator

Okay. Thanks.

A - Vivian Prem Watsa {BIO 16700363 <GO>}

Thank you, Junior (19:05). Next question, Bob.

Operator

Yes, sir. We have Tom MacKinnon back on queue. Tom, your line is open.

Q - Tom MacKinnon {BIO 2430137 <GO>}

Yeah. Thanks for taking my question. Prem, you mentioned with respect to the other parties that helped out with the Allied World acquisition that you have to wait some time before you buy them out. Is - can you flesh that out a little bit? Is there some contraction?

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A - Vivian Prem Watsa {BIO 16700363 <GO>}

Yeah. No, so the ability - it's a transaction that helps us to buy the companies. We used it first at Brit, as you know. And, Tom, more recently, we used it for Allied. And so the ability to buy it, we'll - we can buy, say, 20% in year one, but in the main, you have to wait about three years before you can buy them out. And so, we'll take all of that into account. These are longer-term positions that we've had with our partners, but we take that into account. What's staring us in the faces are our ability to buy our stock back.

Q - Tom MacKinnon {BIO 2430137 <GO>}

Okay. And 20% means 20% of their position or 20% of the entire Allied World?

A - Vivian Prem Watsa {BIO 16700363 <GO>}

20% of their position. So if they've invested \$100 million, 20% of the \$100 million.

Q - Tom MacKinnon {BIO 2430137 <GO>}

Thanks. Okay. Thank you.

A - Vivian Prem Watsa {BIO 16700363 <GO>}

Okay. You're welcome, Bob - welcome, Tom. Bob, any other questions?

Operator

We have no questions in queue.

A - Vivian Prem Watsa {BIO 16700363 <GO>}

So, if there are no more questions, thank you very much for all of you, our shareholders, for joining us on the call. And, Bob, thank you for hosting this. Thank you.

Operator

Thank you. That concludes today's conference. Thank you so much for your participation. You may now disconnect.

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