Acquisition of Brit Plc by Fairfax Call

Company Participants

- David Bonham, Chief Financial Officer & Vice President
- Derek Bulas, Senior Legal Counsel, Legal & Business Affairs
- Vivian Prem Watsa, Chairman & Chief Executive Officer

Other Participants

- Arun N. Kumar, Analyst
- Howard Flinker, Analyst
- Paul Holden, Analyst
- Rötger Franz, Analyst
- Tom MacKinnon, Analyst

MANAGEMENT DISCUSSION SECTION

Operator

Welcome, and thank you for standing by. All lines are in listen-only for the duration of today's conference. The question-and-answer session will be held at the end. This call is being recorded. If you have any objections, you may disconnect at this time.

I'd like to now introduce Mr. Derek Bulas. Sir you may begin.

Derek Bulas

Thank you. Good morning, and welcome to our call to discuss our acquisition offer for Brit Plc. 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 will 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. Welcome to our conference call on our announcement last night about the purchase of Brit Plc. We announced last night that we made an offer to buy 100% of Brit for £3.05 per share in cash, consisting of £2.80

in cash and the expected 2014 final dividend, payable by Brit, of £0.25 in cash to Brit shareholders.

The Brit offer price values the company at approximately £1.22 billion and represents a premium of approximately 20.2% to the six-month volume-weighted average closing price of £2.538 per Brit share, as of the close of business on February 16, 2015. It also represents 11.2% of the closing price of £2.742 pence per Brit share on the same February 16, 2015. And finally, it represents a premium of 27.1% to the offer price of £2.40 per Brit share set at its initial public offering on the March 28, 2014.

The 2014 final dividend is expected to be announced with a publication of Brit's preliminary results on February 25, 2015. Brit's position as a market-leading global specialty insurer and reinsurer, its major presence in Lloyds, and its disciplined approach to underwriting, make it a natural candidate to join Fairfax's expanding worldwide specialty operations. It is one of the largest syndicates at Lloyds, and benefits from the strong financial strength rating of A+ assigned to Lloyds.

Brit's growing U.S. and international reach are highly complementary to Fairfax's existing worldwide operations, and the acquisition further diversifies Fairfax's group risk portfolio. In addition, Brit will be able to leverage Fairfax's expertise in the U.S. and international insurance and reinsurance markets, thus enabling Brit's global product offering and providing it with expanded underwriting opportunities and support.

The Brit Group writes a diverse mix of specialty insurance and reinsurance business, with a focus on direct insurance, where the Group's experienced underwriting teams provide specialist, complex products, and support to clients globally. In the first half of 2014, direct insurance accounted for 74% of the Group's gross written premium, with the remainder of the gross written premium composed of an attractive book of property and casualty reinsurance. The Group's business is also diversified geographically and since 2009, the group has expanded its distribution reach internationally, with the development of a local service company footprint which has generated efficient and profitable growth for the Group across the Americas, Canada, and the United States, Bermuda, and Asia.

Brit is led by Mark Cloutier and Matthew Wilson, Chief Underwriting Officer, and the Company will continue to be run independently under Mark's leadership post acquisition. Brit is one of the leading Lloyds market's operators. In 2013, Brit had revenue of approximately £1.2 billion or in U.S. dollars, $1.8 billion, and earnings of a £100 million, or U.S. $160 million. The Company's investment portfolio is approximately £2.6 billion, or U.S. $4 billion. Brit's average combined ratio for the last 10 years has been 94.4%, with reserve redundancies averaging 6% each year.

The acquisition fits well within Fairfax, as it will significantly raise our profile within the attractive Lloyds marketplace. As well, Brit is a leader in areas where other companies within the Fairfax Group have more limited activity. Both Advent and New Line will continue to be run independently of Brit. With Brit as part of our organization, the Fairfax Group will have a significant top five position in the Lloyds market, and will continue to write business with the Lloyds A+ rating. We know Brit fairly well, as we acquired their (6:00) business in June 2012 and have worked with them closely since the acquisition.

In terms of valuation, our offer price of £3.05 is 1.73 times Brit's tangible assets as of June 30, 2014, and less than 10 times the Company's earnings, based on the Company's annualized net earnings for the six months ended June 30, 2014. The acquisition is accretive to Fairfax on several metrics that we use, including gross premiums per share and investments per share. In terms of financing, our acquisition of Brit will cost us, in U.S. dollars, approximately $1.88 billion or $1.7 billion after the £0.25 dividend. Last week, we announced that Fairfax earned approximately $1.7 billion after-tax in 2014 and ended the year with $1.2 billion in cash and marketable securities.

At the end of 2014, Fairfax wrote approximately $50 of premium for every $100 of total capital that we've had. Fairfax has many alternatives through internal means to finance this acquisition, including using excess capital from within our companies, as well as by realizing profits on readily marketable stocks and bonds, or doing a bond issue. It is also worth noting that we have had reverse enquiries from potential equity partners. We will be examining all of these alternatives in the weeks to come, but rest assured, Fairfax will always maintain exceptional financial strength. We are very excited about the purchase of Brit Plc because of its exceptional underwriting record, and welcome Mark Cloutier and all Brit employees to the Fairfax family.

Now we are happy to answer your questions. Please give us your name, your company name, and try to limit your questions to only one so that it's fair to all on the call. Jennifer, we're ready for the questions.

Q&A

Operator

Thank you again. Please stand by for incoming questions. The first question comes from Arun Kumar from JPMorgan. Your line is open.

Q - Arun N. Kumar {BIO 3260446 <GO>}

Good morning, Prem. Congratulations on the transaction.

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

Good morning, Arun.

Q - Arun N. Kumar {BIO 3260446 <GO>}

Thank you. A quick question for you. You just mentioned that you want to maintain strong financial strength, and that you have various alternatives in terms of financing, internal and external. Would it be fair to say that you're committed to maintaining your current investment grade ratings going forward?

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

Very much, of course. We're very committed to our investment grade ratings. And yeah, we very much expect to maintain our ratings.

Operator

The next question comes from Tom MacKinnon from BMO Capital. Your line is open.

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

Good morning, Tom.

Q - Tom MacKinnon {BIO 2430137 <GO>}

Yeah, thanks very much. Good morning and congratulations on the acquisition. Question just more on the financing. You do have, I guess, over $6 billion in cash. Is it your thinking to keep that total cash position, or how should we look at your cash position, just the Holdco cash, or should we look at the total cash? And with this, do you think some of the financing could actually come from putting to work some of your total cash position?

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

Yes. So, Tom, we've got the $1.2 billion in cash, as we said to you. We...

Q - Tom MacKinnon {BIO 2430137 <GO>}

That sits at the Holdco though, right? Your total cash position is certainly higher?

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

Yeah. Our total cash position is significantly higher. It's another 25% of the $26 billion, $27 billion that we have in our companies. The way we look at it, Tom, as I said, we've got $50 of premium that we write for every – for $100 of total capital. And so we are very under-levered in terms of premiums to capital. We have excess capital in our insurance companies. And so, when you talk about that $6 billion of cash, some of that excess capital we can dividend out and put it into our holding company, increase the cash in the holding company. So we mentioned that we could realize profits on many readily marketable stocks and bonds, that'll increase our – our cash, and increase the ability to move it up to the holding company. And of course, we can do a bond issue. So, we've got many alternatives.

We have partners who in the past have been – have suggested that they would like to be partners with us and – in these insurance operations, and we may consider that, if it's a partner that we're really comfortable with. And all of that just to say, in terms of our common stock, we think our common stock with a book value of $400 a share and a stock price – with a market stock price to book value of about 1.3 times, we think is inexpensive. We're selling – we had a very good year last year. Our earnings are well protected. Our underwriting is – and our insurance operations are very good. Our investment portfolios are very conservative, as you know. We went through it last week. Our equities are hedged. We got 25% cash, low corporate bond. We've got deflation swaps. So we just think that we have many ways of financing this, and one of the last alternatives will be a stock issue.

Q - Tom MacKinnon {BIO 2430137 <GO>}

And what do you think you'd want to take - if you did that, where would you want to take the - like the total debt to total capital ratio? I think it's around 25% - just under 25% now. How high would you want to take that?

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

Yeah. No, we are comfortable with that. I think we've gone up one or two points above - it's 24.6%, it might have gone up to 26% or something like that, Tom, but not a lot higher than where we are today. Yeah, so that's where we are. That's what we're looking at.

Operator

The next question is from Paul Holden of CIBC. Your line is open.

Q - Paul Holden {BIO 6328596 <GO>}

Thank you. Good morning.

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

Good morning, Paul.

Q - Paul Holden {BIO 6328596 <GO>}

I want to ask a couple questions on Brit's underwriting, obviously, since we're not as familiar with that business.

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

Yes.

Q - Paul Holden {BIO 6328596 <GO>}

So you say it's - they underwrite specialty lines and sometimes complex transactions. So I just wanted to get a sense for, how complex is it? Is this the type of stuff where the insured is getting two or three quotes globally, or is it something that's a least - specialty, but somewhat more standardized?

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

Yeah. So, Lloyds, it's a 300-plus-year-old market. In the insurance business, if you can't write business wherever you are in the world, your final alternative is to go to Lloyds. And it's a subscription market. That means you provide a leading line, 25%, 30%, and then others come in and join you. This is one of the largest Lloyds syndicates. Its track record is there for everyone to see. This company, Paul, the last good underwriting company we bought was Zenith in 2010. And so this is similar to Zenith, in the sense it's got an exceptional track record. It's got a worldwide franchise. And Mark Cloutier has joined the company about four years ago, and done an outstanding job in terms of focusing on underwriting profitability with Matthew Wilson, who has been there since 1999. And Matthew is in his mid-40s and he is Chief Underwriting Officer, and has done an exceptional job in underwriting.

And so they have, in Lloyds, the advantages (14:34) have is that you have a large spread of business to choose from, and they have a very underwriting-oriented disciplined company, hundreds of underwriters in the company. And we're just exceptionally pleased with the fact that we could do a deal. Of course, we've locked in the two private equity owners, Apollo and CBC. That's an irrevocable lock up. They own, I think, 73%, 74% of the Company. So this acquisition is going to take place and we're very, very excited. We've known Mark for a long time. And it will be nice to welcome Mark to our company.

Q - Paul Holden {BIO 6328596 <GO>}

Okay. And then, with that 10 year average combined ratio you provided us, which is a helpful number, has there been any shift in focus over that 10 years, or is it - or is the business being pretty consistent with what we're seeing today?

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

Yeah, Paul. That's a very good question. Since Mark took over four years ago, with Matthew Wilson, there's a tremendous focus in underwriting, and they really pruned the business areas where they were not making an underwriting profit, or prospects for an underwriting profit were not high, they basically eliminated, and they've dropped their expenses quite significantly. So we are - their combined ratios - last year they went public. So there is public company expenses. It's all in their press release, which you can see. I guess it was in the ramp of (16:18) the second half - for their first half numbers, you can see all of that, and it's all public information.

And so we just think they've - and they've demonstrated, in their presentations, that the expenses have come down and the underwriting has improved significantly in the last four years under Mark's leadership. And so, we're just very happy to be shareholders now. They will be decentralized. In our structure, they will run the company, just like Zenith is run from California. This will be run from London, with Mark Cloutier continuing as CEO, Matthew Wilson as Chief Underwriting Officer and will be run separately, with the exception of investments, of course, which is centralized, and all these returns have been earned by the company, and we think we'd like to be able to add perhaps to their investment results over time.

Q - Paul Holden {BIO 6328596 <GO>}

Okay. And then final question, if I may, that you suggested that the investment portfolio will be centralized, so it will look more like your current portfolio today over time. Is there anything in Solvency II - again, an area I'm not expert on, but is there anything in Solvency II that would provide some kind of additional regulatory constraints, in terms of how you can allocate the portfolio?

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

Paul, we already operated in Lloyds through Advent and through Newline, and the regulatory approach that the PRA uses in London is very similar to what we have all over the world. So we're used to the regulatory environment, and we don't think it's any more onerous than other environments in the world.

Q - Paul Holden {BIO 6328596 <GO>}

Okay. Thank you very much for your answers.

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

Yeah. Thank you, Paul. Next question, Jennifer?

Operator

The next question comes from Howard Flinker of Flinker & Company. Your line is open.

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

Good morning, Howard.

Q - Howard Flinker

Hi, Prem. Hi, everybody else. If I may, I'd like to ask two questions. One, it looks as if the return on capital for the last year of Brit was about 12%. Is that typical for their last 10 years, or typical for the new management?

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

So this – in the last four years, when you look at return on tangible equity...

Q - Howard Flinker

Right.

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

You will find it higher than that, Howard. And there – as I said in our prepared comments, that I think in February 25 their results come out, and we'll have to wait and see what the results are, but their returns – this is a public company. So there is a ton of public information on it. The prospectus that they came out when they did the IPO is well worth reading for all on the telephone, on this conference call, and you'll get more information on it.

Q - Howard Flinker

Fair. May I ask a question about my ploughing through the long fourth quarter release, or would you rather I do that offline?

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

Yeah. No. You can ask a quick question. I've got Dave right here and if he can't answer it, we'll get back to you.

Q - Howard Flinker

It's pretty simple. I noticed that, from a big picture, your premiums written, gross and net, rose about 5% or 10% last year, and your reserves dropped about 5% or 10%. Can I infer that that reflects some deflationary pressure on your liabilities or loss ratios?

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

First of all, I'd think our net premiums were flat for the year, Howard. But Dave, would you just answer that?

A - David Bonham {BIO 15243784 <GO>}

Sure, Howie. So a number of factors. It's the FX that's in play there.

Q - Howard Flinker

Oh, right.

A - David Bonham {BIO 15243784 <GO>}

Strengthening of the U.S. dollar against many of the major currencies that we have, and then of course I guess our (20:45) favorable development, and probably the runoff of cat losses that we may have had in prior years, that they just weren't as significant this year. So I think those three factors pretty much sum up why our reserves have come down.

Q - Howard Flinker

So you think it's just ordinary net favorable development and not yet any deflationary pressures on your costs?

A - David Bonham {BIO 15243784 <GO>}

No. That's right; that is yet to come, Howie.

Q - Howard Flinker

Okay. Thanks guys. Good, thanks.

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

Thank you Howard. Next question, Jennifer.

Operator

The next question is from Rötger Franz of Société Générale. Your line is open.

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

Good morning Rötger.

Q - Rötger Franz

Hi, thanks for allowing my question. You said that Brit will operate independently within Fairfax, and now we actually have this old Brit's 6.8% lower Tier II bonds still outstanding. So what does it actually mean for future issuance and funding, as well as the probability that you will meet bondholder expectations, that the bundle will be called at the first call date?

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

Well, Rötger, thank you for that question. But of course we'll review all of that once we close the acquisition. In the past, we've maintained whatever debt we've had in each of these companies, but over time, it's gravitated towards the holding company, where we finance in the holding company. But we'll review that Rötger, when - after we close this acquisition, which is subject of course to regulatory approval.

Q - Rötger Franz

Thank you.

Operator

The next question is from Tom MacKinnon of BMO Capital. Your line is open.

Q - Tom MacKinnon {BIO 2430137 <GO>}

Yeah. Thanks for taking another question. Just looking at the dividend capacity out of (22:30) what would you say that would be on an annual basis? Are we in the area of $500 million to $600 million annually out of these operations?

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

Yeah like conceptually, Tom, I've said over some time that we've looked at it as a $500 million to $1 billion as the range of dividend capability from our company, depending on the year, depending on the business that we write. So that hasn't changed, that range, $500 million to $1 billion. But there were many moving parts, Tom, in the sense that we've got - as I mentioned, we could realize profits on many stock positions that we have, any bond positions that we have, and of course that frees up even more capital, and as you pointed out, we've got lots of cash in the insurance operations.

So we've - we have a lot of financial flexibility, Tom, in terms of financing this acquisition. Just if you step back, we made $1.66 - say $1.7 billion last year net income after tax. This whole company was going to cost us $1.7 billion. And so it's well within our - Palladia (23:49) capital base is about $8.5 billion in terms of equity capital, not anything else, and our market cap is, I think, in U.S. dollars, through $10 billion. So this is a significant acquisition for us, but well within our ability to digest it, and we've said to the marketplace some time, we want to buy good companies with good underwriting track records. Zenith was a case in point, and Brit is certainly a good case in point, and Brit has in it – on top of all that – Brit has the world, in terms of its ability to underwrite properly. (24:35) And for that reason, we're very excited about the possibilities of Brit.

Operator

Your final question is from Paul Holden, CIBC. Your line is open.

Q - Paul Holden {BIO 6328596 <GO>}

Hi. Thanks. So I have to ask one more. With the addition of this business and the additional specialty lines capabilities, would you expect to shift more premium and capital away from your existing reinsurance business to Brit?

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

No, we don't expect to do that. There's all sorts of possibilities, but each of our companies are run independently. So Odyssey is run independently, Newline is run independently. And so, Paul, we'll look at running these companies independently. Advent is an independent syndicate run by Nigel Fitzgerald, and that's how it's going to be. Nigel runs it. He runs it separately. And he's going to work with Mark, and work with our Newline operations. But they're all run independently.

So, when we buy a company, the risk that the companies have in terms of mergers and the politics of putting two groups of people together, with us that's never been the case. Zenith is a great example, it's run totally decentralized. The only difference was the investment side. And I think it's fair to say, we haven't lost a single person there of any significance in Zenith. And we expect the same in Brit.

Q - Paul Holden {BIO 6328596 <GO>}

Okay. Thank you.

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

Thank you, Paul. Jennifer, any further questions?

Operator

No, there are no further questions.

Q - Paul Holden {BIO 6328596 <GO>}

Well, Jennifer, thank you very much for this conference call. As there are no more questions, we thank all of you for joining us on this call. Thanks again.

Operator

That concludes today's conference. Thank you for your attendance. You may disconnect at this time.