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Insurance runs

Evan Lorenz writes:

The Federal Reserve says it intends to keep short rates pinned to zero through 2023 to cook up a little inflation. In the insurance industry, at least, Chair Jerome Powell has already succeeded. Now in progress is a bullish analysis of one beneficiary of the new pricing environment, the insurance conglomerate Alleghany Corp. (Y on the Big Board).

Sticker shock awaits any who would try to renew his business coverage. Only hear Chris Knibb, CFO of Soc Telemed, Inc., sing the blues on a March 30 earnings call: "[O]ur public company costs are expected to be higher than previously guided as directors' and officers' insurance expense is about $3 million higher than what we had anticipated, as the market for SPAC-related insurance increased dramatically throughout 2020."

When interest rates stood tall, investment income tended to supplement the profitability of the core underwriting business. No more, needless to say. Alleghany earned 2.5% on an investment portfolio that averaged $18.2 billion in 2020. Today, the rate on offer is 1.5%. "This means that if nothing changes, the $19.0 billion of invested assets that existed at the end of 2020 will ultimately earn $285 million, or about 63% of the 2020 actual when they mature and are reinvested at today's interest rates," CEO Weston Hicks wrote in his 2020 letter to shareholders.

Nor have underwriting profits bridged the gap. Natural disasters dealt the North American property-casualty business an average annual loss of $37.3 billion between 2010 and 2016; for the past four years, that toll has more than doubled, to $76.5 billion. The battering has, at least, discouraged new capital from entering a business that has chewed up so much of the money that was previously committed to it.

Unpopular on Wall Street, the insurance business seems no better loved on Main Street. Thus, last October, a jury awarded $411 million to a motorcyclist who ran afoul of a tractor-trailer. Jury-assessed damages in excess of $10 million, known in the trade as "nuclear verdicts," are common enough so that, according to an October survey by the American Transportation Research Institute, the cost of insurance has become the fifth biggest concern for truckers. Not since 2005 had insurance figured in even their top-10 worries.

"If someone wins $20 million from the jury, my insurance companies only pay the first $5 [million]," a March 24 CNBC article quoted Mike Card, the president of Combined Transport, Inc., as saying. "I would have to pay the next $15 million. We couldn't afford that. We'd have to shut our doors." There's a term of art for the courtroom costs of this animus toward business. Cognoscenti call it "social inflation."

Liberty Mutual Insurance, which explores the phenomenon on its website, does not forget the interest rate angle. Normal-size rates would give hedge funds the scope to pursue such constructive work as buying value stocks and selling short tech frauds. As it is, the portfolio managers are reduced to fronting the money for plaintiffs' lawyers in exchange for a portion of a favorable verdict. Plaintiffs so financed have every incentive to swing for the fences.

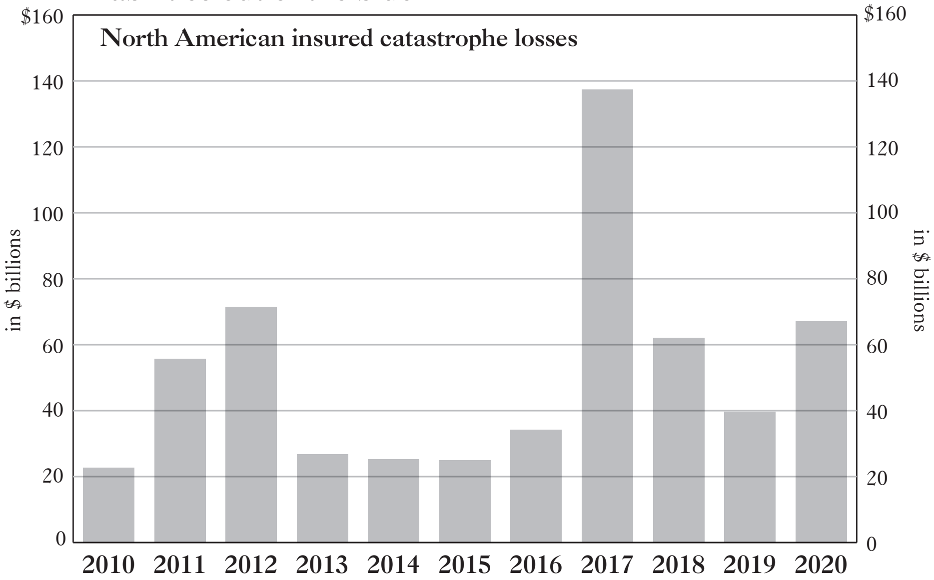
"You can't watch a Chicago Bulls basketball game without seeing at least five different personal-injury attorneys," says Steven Shapiro, CIO at Highland Park, Ill.–based New Vernon Wealth Management, LLC, a fund that focuses on the insurance sector. "I'm not kidding."

Short-lived insurance cycles have dominated for the past 30 years. As losses mount, providers hike rates, which attracts new capital. The new capital, in turn, pressures premiums. But maybe this cycle is different. Depending on the specific line of business, premiums have been rising for three years. "There's a lot of prior cycles where you'd be done at that point," Matthew Carletti, who rates Alleghany a buy for JMP Securities, LLC, tells me. "But we still have lines of business that are accelerating rate increases, not plateauing. I think it's fair to say that this cycle has some legs to it."

You can see the absence of cyclical legs in the prior financial results of the reporting companies. Thus, since the end of 2016, the insurance component of the S&P 500 has generated a 51% return versus a 100.7% jump in the overall index (both figures include reinvested dividends). Nevertheless, omens appear favorable. Losses absorbed in 2021 will largely stem from business written in 2019 and 2020. Today's firmer pricing environment could propel earnings for the next several years, barring shockingly high catastrophe losses.

"I think the insurance industry is being overlooked," says Steve Virgili, a portfolio manager at New Vernon, which holds a position in Alleghany. "Insurance results are going to be better this year

Liabilities out of the blue



source: company reports

and next year than people probably appreciate, which means earnings growth is going to be…on par with the broader S&P 500. Yet, the insurance industry trades at 10–12 times earnings compared to 22–23 for the market."

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A century ago, the resplendently named Van Sweringen brothers, Oris Paxton and Mantis James, amassed controlling stakes in five major railroad systems, which accounted for almost one-fifth of the track in the United States. The duo chose 1929 as the year to list Alleghany as a holding company for those positions, but leverage paired poorly with the Great Depression and the roll-up filed for bankruptcy protection five years after its formation.

In 1937, Robert Young, a former General Motors Co. treasurer, and Allan Kirby, an F.W. Woolworth Co. scion, purchased control of Alleghany. Wikipedia says Young "used the company as a vehicle for his vendetta against the J.P. Morgan banking interests." However that may be, he and it survived the rugged stock market liquidation of 1938.

Over the course of the next eight decades, Alleghany pivoted to and from different business lines. It traded out of railroads in 1966 and back into railroads in 1994. It owned dominant players in mutual-fund management, such as Investors Diversified Services, Inc., which it purchased in 1949 and sold to American Express Co. in 1984, and in title insurance, such as Chicago Title and Trust Co., which it bought in 1985 and spun out to shareholders in 1998. Alleghany has also dabbled in businesses as diverse as toy manufacturing and metal fabrication.

"In 2000 and 2001," Hicks wrote in his 2019 letter to shareholders, "Alleghany had made some very well-timed divestitures, but the result was that the company's operating businesses were a small part of the overall enterprise value of the company. Approximately $1 billion of the $1.4 billion in stockholders' equity was comprised of passive assets—primarily Treasury bonds and a large stake in Burlington Northern Santa Fe, which Warren Buffett stole* from us!"

Under Hicks, a former CFO of the insurer Chubb Ltd., Alleghany has focused on insurance. Key acquisitions include Capitol Transamerica Corp. (for $182 million in 2002), rebranded as CapSpecialty; RSUI Group, Inc. (for $628 million in 2003); and Transatlantic Holdings, Inc., or TransRe to its friends (for $3.5 billion in 2012).

CapSpecialty insures, among many other things, daycare centers, beauty parlors, medical practices, asset-management businesses, construction sites, the directors and officers of public corporations, and it writes surety and fidelity bonds. RSUI focuses on the wholesale specialty insurance market. It deals in property, casualty and professional liability lines requiring expert underwriting. In standard insurance, providers sell coverage for uniform and predictable exposures, e.g., consumer auto lines. Specialty insurance provides coverage for niche risks and randomly occurring exposures.

TransRe earns two-thirds of its premiums from casualty reinsurance, meaning coverage for damages done by or to business, and the balance from property reinsurance. North America contributed 70% of the top line, followed by Europe (18%), Asia Pacific (7%) and Latin America (5%).

Taking a page from Berkshire Hathaway, Inc., Hicks began using a portion of the insurance float in 2011 to invest in operating businesses (collectively called Alleghany Capital). Portfolio companies include W&W|AFCO Steel, LLC (a manufacturer of fabricated steel used in construction), Wilbert Funeral Services, Inc., Jazwares, LLC (a toy maker), IPS-Integrated Project Services, LLC (engineering, procurement and construction management for the pharmaceutical industry) and Concord Hospitality Enterprises Co., LLC (a manager and developer of upscale hotels).

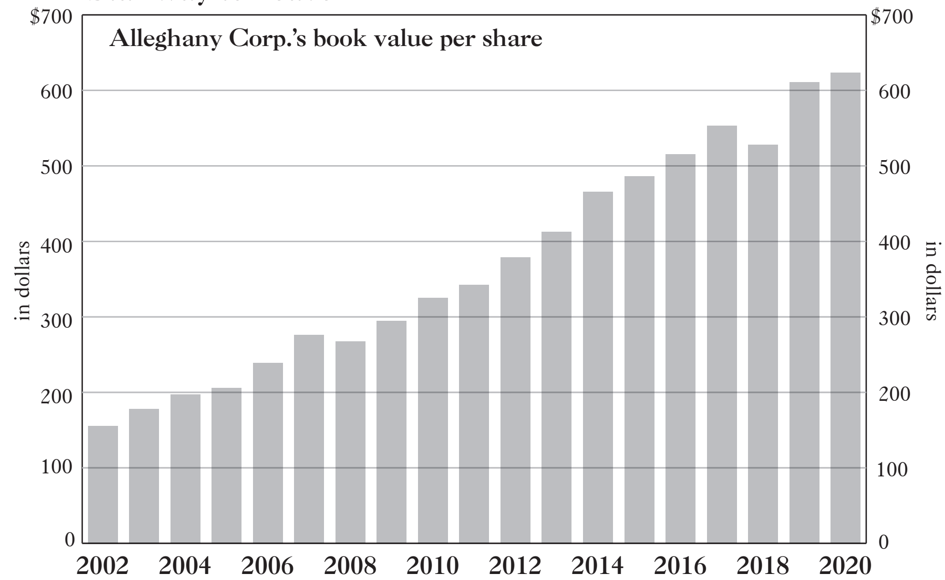
RSUI, Alleghany's crown jewel, has delivered a net $1.8 billion in underwriting profit since its 2003 acquisition with only two years of losses. TransRe, which generated a net $850 million in underwriting profit since its 2012 purchase date, has had a bumpier ride. Recurrent catastrophes and depressed pricing led to $684 million in losses between 2017 and 2020. CapSpecialty, the lone insurance problem child, has produced a cumulative underwriting loss of $85 million over the past eight years. In 2019, Jack Sennott, then Alleghany's CFO, moved in to conduct a turnaround, and returns are expected to improve by the end of this year.

In 2020, Alleghany served up $8.9 billion in revenue, with insurance premiums accounting for 67% of the total, non-insurance 28% and net investing income just 4%. TransRe delivered 76% of net premiums written with the balance from primary insurance (RSUI and CapSpecialty).

Overall in 2020, Alleghany insurance

* A friendly jab at Berkshire Hathaway, Inc. for its 2010 purchase of Burlington.

Stairway to heaven



source: The Bloomberg

operations were unprofitable, with expenses and losses weighing in at slightly more than premiums earned—102.1%, to be exact, that being the "combined ratio," the standard industry measure of profitability. Clearly, the lower that ratio, the better. TransRe brought up the rear of the insurance division with a combined ratio of 103.6%—reciprocally, the higher the ratio, the worse. In sharp contrast, the Alleghany Capital companies had a good pandemic, with, on a year-over-year basis, revenues increasing by 8% and operating income by 31%.

While Alleghany should benefit from stronger insurance pricing, questions surround the C-suite. On March 3, CEO Hicks, age 64, announced his retirement, effective at year end. Two weeks later, the CEO of TransRe, Mike Sapnar, 54, said that he will be leaving the company after a 26-year stint to join Stone Ridge Asset Management, LLC.

Mitigating these losses is Alleghany's reputation for the depth of its talent pool. Hicks will be succeeded by Joseph Brandon, who served as the CEO of Berkshire Hathaway's General Re unit from 2001 to 2008 and has been Alleghany's executive vice president since 2012. "We've been fortunate enough to meet some of their senior team around the globe . . . and wherever you go, it's always top-notch," Carletti tells me. "When you do a trip and meet with 10–15 people, it's always the TransRe person who was most thoughtful, who knows the market. They always have some of the best people wherever around the globe you go."

There'd be lots to like about the former railroad roll-up even if its head man hadn't chosen to quote *Grant's* in his 2020 letter to shareholders. Alleghany underwriters draw pay according to the profitability, not the volume, of the business they write. In consequence, Alleghany's insurance business tends to shrink when returns are scant and to grow when prospective returns increase. "We are a contrarian underwriter," Phillip McCrorie, president of the RSUI group, declared on the Nov. 6 analyst day.

Perhaps most insurers would declare the same, but, for the most part, says Phil Stefano, who rates Alleghany a buy for Deutsche Bank A.G., most companies don't deliver on that pledge. Arch Capital Group Ltd. and Alleghany are two notable exceptions.

At Alleghany, executive compensation also seems tailored to the interests of the stockholders. Management is gifted no stock options, but rather must hold stock in proportion to his or her pay. The holding requirements are based on whichever is greater, the share price or the book value per share, so the C-suite would be required to buy more shares if they destroy shareholder value. Nor may such shares be pledged or hedged. Hicks, for example, must hold five times his base salary of $1.125 million in Alleghany common; in fact, he owns $43.5 million. Incentives are tied to the growth in book value per share, and the board can vote to claw those carrots back "to further discourage imprudent risk taking," as the proxy puts it.

Rated A-minus by A.M. Best Co., Alleghany's balance sheet is lightly leveraged with net debt of $1.3 billion, amounting to 15% of equity as of Dec. 31. The 22 insurers in the S&P 500 show an average debt-to-equity ratio of 39% at year end. In the insurance industry, operating leverage is measured by comparing net premiums written to book value; Alleghany's premium-to-surplus ratio last year was a modest 0.9.

Rising claims costs can tax the reserves that insurers set aside for losses in prior years, but Alleghany is known for its conservative underwriting. "I don't have concerns about the company's reserve position, which I think is something that is probably unique to the market," Stefano tells me. "People can't poke holes in the reserve base."

Insurance, too, is a kind of play on the reopening economy. You see it, or will shortly see it, in lines as various as workers comp and accounts receivable. At Alleghany, you're seeing it, too, in the fattening order books of Alleghany Capital's operating businesses. Thus, W&W|AFCO's backlog stands at $1.4 billion, up from $0.8 billion in 2020, and IPS's backlog has more than doubled, to $1.1 billion, from last year's level. W&W, a maker of the kind of steel used to build bridges, overpasses, etc. would have no objection if the Biden administration infrastructure initiative got funded, while Concord, the hotel service provider, is leveraged to the return of travel.

Curiously, Alleghany is a bit of an analytical orphan. The average company with a market cap of between $8 billion and $10 billion is rated by 13 analysts. Alleghany, with a $9.3 billion valuation, is covered by just two, both of whom say buy. Perhaps the herd would be more attentive if Alleghany played along with providing financial guidance (not so easy in an industry in which one's biggest liabilities are unknown) and staging quarterly conference calls.

Management targets 7%–10% annual growth in book value per share. Over the past 15 years, it has delivered 7.4%, but over the past five years just 5.1%. The happier pricing environment should change that. "We've got about 7% to 8% growth in 2021," Carletti tells me. "I've got about 9% in 2022. So right within that band."

Alleghany trades at 106% of book value and 10.9 times the 2022 earnings estimate. The insurance component of the S&P 500, by comparison, changes hands at 131% of book and 12.2 times the 2022 estimate. Over the past year, insiders have restrained their enthusiasm, purchasing 50 shares at a cost of $31,987. No one has sold.

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