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Book's closed

The road to riches is poorly marked, long and winding. Enstar Group (ESGR on the Nasdaq), which travels some of the most remote stretches of that storied thoroughfare, is the subject at hand. In preview, we're bullish on it.

Enstar buys runoff insurance policies. It manages them, pays off the relevant claims, oversees the investments that fund them and harvests the redundant loss reserves. It buys nonlife policies (74% of assets) and life insurance policies and annuities (16% of assets). It underwrites its own line of non-life insurance besides (10% of assets). From 2006 through 2013, the company generated compound annual growth in book value per share of 19%. No dividends are paid—naturally. With that record of internal growth, who'd want them?

The corporate womb from which Enstar improbably sprang was that of America's largest day-care operator. In the 1980s, KinderCare Learning Centers was a financial satellite of Drexel Burnham Lambert, the old junk-bond procurer. The watchful steward of little children became a leveraged acquisitions' machine. It bought up shoe stores, the hunting magazine *Buckmaster* (a particularly strong corporate fit), an Israeli chemical company and a thrift institution, American Savings & Loan Association of Florida. By 1990, KinderCare—now, after a spin-off of the day-care business, renamed Enstar—was borrowing from the S&L to finance a fast-depreciating inventory of Drexel's high-yield securities. Federal law enforcement officials were closing in on the well-founded suspicion that top people at KinderCare were filching commitment fees owed to the company.

Nimrod T. Frazer, an Alabama investment banker, became the sinking vessel's emergency CEO, succeeding Drexel-tainted management, two of whom went to jail. Frazer's strategy was to sell everything except the thrift, whose capital account he transfused with the proceeds of the asset sales. In 1991, he led the company into bankruptcy. "A long story short," Frazer tells colleague Evan Lorenz, "we liquidated everything else and then we turned the thrift around."

And when, a few years later, the post-bankruptcy Enstar sold the thrift it had resurrected, what remained was cash and a net operating loss carryforward. There was, however, no operating business. What to do between the hours of nine and five? The esoteric business of runoff insurance presented itself. Enstar took the plunge in company with a trio of rising Bermuda-based insurance men—Dominic Silvester, Paul O'Shea and Nick Packer. The three called themselves Castlewood Ltd. Today's Enstar has a $2.5 billion market cap (though a much smaller float) and upwards of $8.7 billion of assets under management as of

Enstar Group Ltd.
(in $ millions, except per-share data)

	2013	2012	2011	2010	2009
Assets					
Cash and investments	$6,561.3	$4,307.8	$4,558.8	$3,884.5	$3,321.1
Reinsurance balances recoverable	1,363.8	1,122.9	1,789.6	961.4	638.3
Other	695.1	447.6	257.7	390.0	211.4
Total assets	8,620.2	5,878.3	6,606.1	5,235.9	4,170.8
Liabilities					
Loss reserves	4,219.9	3,650.1	4,272.1	3,291.3	2,479.1
Policy benefits, life and annuities	1,273.1	11.0	10.8	-	-
Other	1,048.8	441.9	639.8	728.8	615.6
Total liabilities	6,541.8	4,103.0	4,922.7	4,020.1	3,094.7
Redeemable non-controlling int.	100.9	-	-	-	-
Non-controlling interest	222.0	221.5	297.3	267.4	274.2
Shareholders' equity	1,755.5	1,553.8	1,386.1	948.4	801.9
Total liabilities and equity	8,620.2	5,878.3	6,606.1	5,235.9	4,170.8
Earnings per share	12.49	$10.10	$10.81	$12.66	$9.84
Book value per share	105.20	$93.30	$82.97	$71.63	$58.06

source: company reports

the March 31 statement date; an April merger will push the June balance-sheet footings to around $10.7 billion (of which more below).

To describe the Enstar business model is simplicity itself: Perform the most exacting due diligence on prospective investments in the likes of environmental claims or workman's compensation policies. Recover value from the acquired reserves, including reinsurance assets. Earn investment income sufficient to cover operating expenses. It's not so simple in execution, though. "This is an art, not a science," attests Richard Harris, Enstar's chief financial officer.

From whence comes the supply of runoff insurance claims? What determines the demand for them?

The gods of leveraged finance are one source of supply, regulatory pressure is another. Both were at work in March 2011 when a division of Enstar was able to buy a Citigroup life insurance subsidiary for $21.2 million, a 38% discount from its $34.3 million book value. "One of the things we love about this business," says Robert J. Campbell, Enstar's chairman, "is as fast as we can resolve these liabilities, the industry has a habit of creating more."

What to pay for this manna is no easy calculation. Enstar engages actuaries to opine on the claims reserves, lawyers and accountants to weigh in on legal and tax matters. Reinsurance assets, claims files, underwriting files and investment assets all come in for scrutiny.

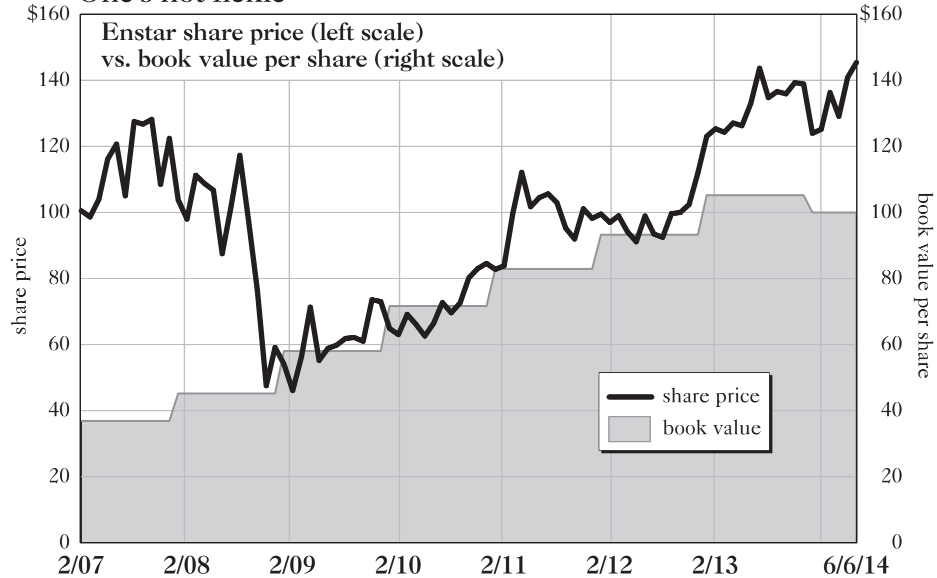
The point of the search is to determine what Enstar could earn by skillfully managing the liabilities. For instance, in the case of asbestos-related liability claims, there might be room to negotiate with claimants. "You, Mr. or Ms. policyholder, seem to expect a $50 million settlement in 10 years," the friendly adjuster from Enstar might say. "Nothing's certain in life, and nobody's getting any younger. How about $25 million tomorrow?"

Nor do books of runoff insurance policies come neatly packaged from Amazon.com. Nick Packer, Enstar's co-chief operating officer, reportedly spends half his working life on airplanes searching for viable acquisitions. Each book of business is bespoke. Each must be stocked with adequate reserves before the time of sale. Capital-impaired companies are not always in the best position to sell the insurance policies they would love to be rid of. "It usually doesn't happen until the would-be seller has raised sufficient capital to mark its claims to market, hired a new CEO or—a different state of affairs—decided to enter liquidation," observes Lorenz. "Enstar could be five or 10 years in talks with a prospective seller before a deal is struck. It's thought that the gradual introduction of Solvency II, a new set of prudential insurance rules in the European Union, could help to shake out some new supply. In that respect, Enstar is the unusual financial business that stands to benefit from heightened post-crisis regulation, rather than to be victimized by it."

"There are hundreds of billions of dollars of liabilities sitting on companies' balance sheets around the globe and in the United States," says Chairman Campbell. "There is no shortage of potential business."

It's all very well when reinsurance supports the liabilities that Enstar buys. Complications arise when the reinsurer can't pay. As of March 31, Enstar counted $1.6 billion of reinsurance assets on the balance sheet, of which high-rated names stood behind $1 billion. For the rest, a bad-debt reserve exists in the sum of $340 million, a high reserve as the industry reckons such provisions. It speaks well of management's persistence that it's been able to generate $141.4 million of income between 2008 and 2013 by collecting reinsurance assets that it had previously written off as doubtful.

One's not fickle



sources: company reports, Bloomberg

Not just anybody can do what Enstar does. Berkshire Hathaway is in the business, and so is Fairfax Financial Holdings Ltd. of Toronto. There are smaller competitors, too, like Catalina Holdings Ltd., a Bermuda venture closely held by, among others, Caisse de Depot et Placement du Quebec, Apollo Global Management LLC and the Ontario Teachers' Pension Plan Board. Many of the hedge funds that tried their hand at the runoff business have withdrawn.

It's not that the hedge funds couldn't execute on the investment side. The risk might lie in their executing with an excess of risk-taking. Enstar has plenty of risk in its insurance liabilities. It pays out around $500 million a year in claims. It writes letters of credit. What it needs is liquidity. It follows that safe and short-dated fixed-income securities are its investment assets of choice.

From which it also follows that—as long as radical central bank policies are in place—safety comes with a price. Enstar must forgo interest income for the sake of reducing interest-rate risk. Last year's portfolio returns fell to 2.8% from 3.4% in 2012 and would have been lower without some $805 million of equity, private equity and real estate investments (the overall investment portfolio totals $6.8 billion). Then, again, the company stands to benefit if rates ever do go up. If interest rates had made a parallel move up by one percentage point along the yield curve in the first quarter, net income would have been higher by 73 cents a share, at $2.50 a share.

Incidentally, the Enstar brains' trust is bearish on bonds. It expects yields to rise, though (like many of the rest of us) it isn't sure when. That interest rates may stay where they are for the next three or four years it counts as a material risk.

The style-drift police may have scowled over Enstar's purchase last year of Atrium Underwriting Group Ltd. and Arden Reinsurance Co. Each is in the underwriting field, a line of business that Enstar had logically eschewed. "After all," as Lorenz notes, "the company exists to exploit underwriting error." Campbell et al. insist that they do not intend to build a conventional underwriting franchise. They rather mean to apply the knowledge they glean from their new subsidiaries to win more runoff books. Besides, not every policy acquired in every closed-book deal should be allowed to run off; some can be profitably retained. As a kind of belt to wear with its new pair of suspenders, Enstar says it's brought in Stone Point, a known and successful quantity in insurance underwriting, to take a 40% equity interest in each deal involving the underwriting of new business.

On April 1, Enstar completed its purchase of Torus Insurance Holdings, a global property, casualty and specialty underwriter (it's the previously cited investment that will enlarge the consolidated balance sheet by $2 billion). Torus came into the world only six years ago. "They started their business and were seeking to grow the business in very, very difficult underwriting times with some major catastrophes out there," O'Shea said on a rare company conference call last summer. To which he added, "So, between business expansion and catastrophes, their last few years have not been exceedingly profitable." From which, Silvester elaborated, "Poor results in underperforming areas mask substantial well-structured and profitable business within the Torus group."

Enstar says its angle of approach with Torus is to unwind unprofitable business while nurturing the profitable. As with other such transactions, i.e., the ones involving "live" underwriting, Enstar will partner 60/40 with Stone Point. Since the purchase price is less than net asset value, Torus is expected to provide a lift to Enstar's book value per share—by how much won't be known until the closing of the second-quarter books.

Enstar cut its teeth in other than life insurance, which affords more scope for managed outcomes than the field of human mortality does. "The reserves and the underlying liabilities of a life business really are what they are, and there is not much you can do about that post-acquisition," CFO Harris notes. "The key is really pricing at the time of acquisition, making sure we've got the right platform to administer the business and deal with each of the policyholders and making sure we've got the right investment strategy."

Last year's acquisitions of Household Life Insurance Co. of Delaware and HSBC Insurance Co. of Delaware provide cases in point, management says. For the pair, Enstar paid book value on the nose, which amounted to $155.6 million. One may doubt that book value represented a bargain. The edge that Enstar brought to that transaction and to others like it lies in the nature of a runoff business.

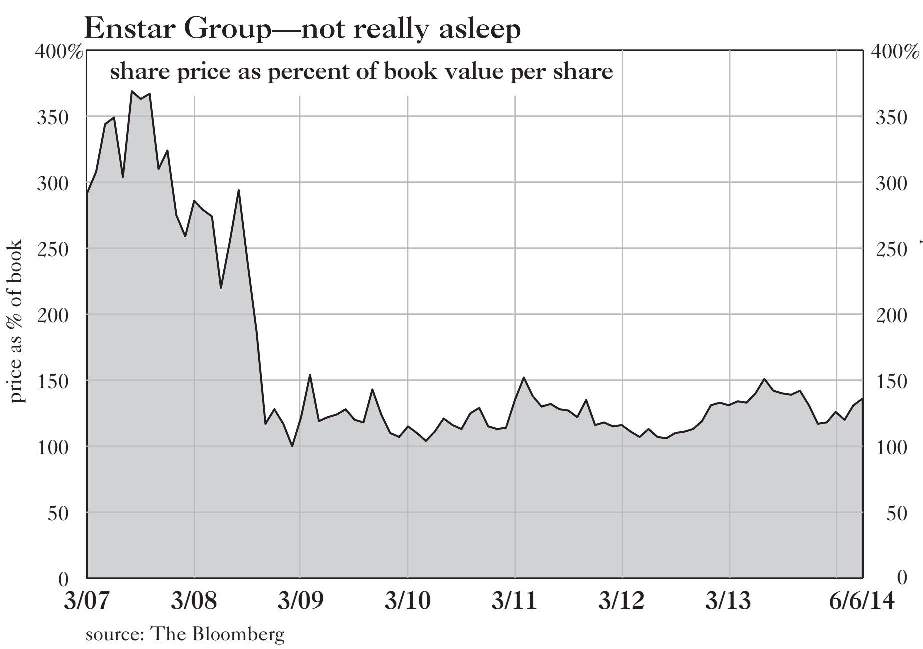
Going concerns demand people and infrastructure of a certain high caliber. Fewer such resources are required for the kind of palliative care in which Enstar specializes. "HSBC had around 120 staff when we took that on and we've got about 45 people," Harris says. "Having a leaner staff, cheaper systems, I think that becomes a very scalable platform that we can utilize on more acquisitions."

Still, because Enstar made its mark in non-life insurance, a skeptical analyst may wonder about the risk of mission creep. We put the question to Steve Shapiro, general partner of New Vernon Insurance Fund, Highland Park, Ill.: "Why would Enstar stray from what made it successful?"

Shapiro fingered interest rates. The reason companies like Hartford, XL and AIG are unloading pieces of their life insurance businesses is that today's low bond yields make them uneconomic. "By eliminating these blocks of business," says Shapiro, "the seller can effectively enhance its go-forward ROE, which is how it would like to be valued."

Then, too, life insurance is a more stable generator of cash flow than the non-life variety, as Lorenz points out: "Blocks of non-life runoff come up for bid intermittently, and while Enstar has historically been able to reduce reserves through commutation and prudent claims' management, earnings can move dramatically quarter-to-quarter. The life business is more predictable. It generates a steady inflow of premiums."

One of the pleasant occupations of the Enstar bulls is to try to divine the underreporting of true corporate book value. Students of the company agree that Enstar's insurance reserves are conservatively overstated. By how much? The so-called triangle tables published in the Enstar 10-K report



source: The Bloomberg

provide a clue. These are data that show the annual progression of reserves and losses. The former consistently outgrows the latter.

"In no vintage year has the company ever under-reserved," an Enstar shareholder points out (he asks to go unnamed). "The degree to which they are over-reserved ranges from 10% cumulative in 2004 and 2007 [i.e., 10% of reserves booked in 2004 and 2007 have since been released into earnings to date] to 84% in 2003. In 2005, they over-reserved by about 60%. What is the average over-reserve? They would tell you it's about 20%, and you can net-present-value that back assuming that the reserve development might take five to six years.

"I think it is really more than 20%," our source continues. "Why wouldn't they tell you it's more than 20%? They have an incentive when they are negotiating these deals to not publicize how much they are scalping the seller. A decent rule of thumb is north of 20% positive reserve development over time." Then, again, this inferential surplus must not be confused with cash. "It takes forever to liquidate anything," another observer says. "If they decided to go out of business tomorrow, God knows how long it would take to get all that money commuted."

Because Enstar manages more than three-dozen subsidiaries, the company may seem to bear more than a passing resemblance to our new best friend, Valeant Pharmaceuticals International (*Grant's*, March 7). You may fairly ask how we can be bullish on the former yet bearish on the latter.

Lorenz has given the matter some thought. "Since 2000 under CEO Silvester, Enstar has bought more than 60 companies and blocks of business," he points out. "Since 2008 under CEO J. Michael Pearson, Valeant has made more than 100 acquisitions. The companies that Enstar and Valeant purchase tend to decline, intentionally for Enstar, unintentionally for Valeant.

"Here the similarities end," Lorenz continues. "Enstar holds itself to a standard of growth in GAAP book value, Valeant to a non-GAAP measure it chooses to call 'cash' earnings per share, though it bears resemblance neither to GAAP earnings per share nor free-cash-flow per share. Enstar issues no earnings releases and hosts no conference calls. The inquiring analyst must rather crack open a 10-Q or 10-K report. As to the Valeant approach to investor relations, let us only say it is more energetic. Enstar has a low tolerance for debt, with just $485 million incurred against $2 billion in equity. Valeant owes $17 billion net of cash."

Or, rather, we should say, Enstar has a low tolerance for financial debt. Its most important liabilities are the ones it's insuring against. And as to those, who really knows? "What really keeps me up at night," Campbell confesses to Lorenz, "is for all the growth we've had, there is something that we missed in our due diligence—that something creeps out that we missed. It hasn't happened but that is always a risk that can emerge."

To which Harris adds: "A change in a law or there could be some form of a latent disease that no one is aware of. We thought lead paint could be something like that but it hasn't been the case. Tobacco could have caused these sorts of issues but that seems retained within the tobacco industry. At some point, there could be issues with radiation from mobile phones, or something like that."

Other risks may seem more immediate to an Enstar shareholder than cancer or the iPhone. One of these potential perils is the risk that any business bears when it's managed by its founders. The aforementioned Silvester, aged 53; O'Shea, 56; and Packer, 51, are still on the job. None was born to wealth, or so we understand. All have earned it. Now some are cashing in. The top four officers (including Richard Harris) have unloaded 160,681 shares in the year to date, for cumulative proceeds of $20.9 million. They continue to hold more than 1.8 million shares worth $268 million.

The fact is that Enstar is a kind of publicly traded, private-equity venture. Officers, directors and institutions—Goldman Sachs, Stone Point and First Reserve, among the latter—hold 47% of the outstanding 15.8 million shares. Its $2.5 billion market cap notwithstanding, the company trades only 23,000 shares a day worth $3.4 million. At $146.73 a share, the stock changes hands at 10.8 times trailing net earnings and 137% of March 31 book value.

Do you wonder what the consensus of Wall Street opinion might be as to forward earnings? The two analysts on the case really have no solid basis for making a forecast (nor do we). "While we provide estimates for Enstar on an annual basis…," Dowling & Partners Research says in a March 6 report, "[i]n reality, even annual earnings for Enstar tend to be lumpy given the nature of the runoff business."

"If you are a stock trader, you don't need to be fooling with this stock," says Frazer, who says he continues to hold most of his wealth in Enstar shares. "This is an investor's investment." High praise.

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