HollAnd Advisors

Holland Views – Fairfax Financial: Price: US$495 - MCap: US$14.1bn

Floats, Operational gearing and buy backs

Our enthusiasm for Fairfax Financial remains. With the prospect for the group making a future ROE of 15% and with the shares trading close to Book Value this suggests they could be trading on an implied PE of c.8x. This combined with the prospect of 15% of compound growth rate and a stated desire to buy significant amounts of their own shares back should be enough to have investors looking hard at this stock. We re-attach our previous work on the company and below we highlight a few extracts from the companies' year end investor letter. In it Prem Watsa (CEO) is more explicit that ever on how the group will achieve its started growth in Book Value per Share of 15% pa. He also again reiterates the past references made to Henry Singleton and the passion he had for aggressive share buy backs. It was this reference that sparked our interest in Fairfax a year ago as we noted the dramatic difference between the famous share cancelling actions of Singleton and the up to now share issuance of Fairfax. Much is changing at Fairfax today as Watsa suggests the required platform for growth is now built so buy backs of their own stock are now a priority for "the next 10 years".

Trough insurance cycle earnings

A point of caution that historically has kept a few people away from such shares has been the insurance cycle i.e. 'We get the float idea that you are presenting but is they're not a risk with the insurance cycle'. This has always been a fair criticism, but today it arguably no longer true as 2017 was a year of wide and extensive insurance industry losses:

> *"The market experienced an exceptionally difficult year in 2017, driven by challenging market conditions and a significant impact from natural catastrophes. These factors mean that for the first time in six years Lloyd's is reporting a loss.*
>
> *The world's oldest insurance market made a pre-tax loss of £2bn last year, compared with a £2.1bn profit the previous year. The group's combined ratio – a measure of claims and costs as a proportion of premiums – worsened from 98% to 114%.*
>
> **Lloyds' Insurance CEO March 2018**

Fairfax financials 2017 rise in its Book Value figure hides this very tough year for claims. Notably the company's balance of investment and insurance earnings means it could still protect or grow its net worth in such a tough year. Also, its combined ratio while high is notably lower than that achieved by the combined expertise at Lloyds of 114%. However, two interesting points of operational gearing that could benefit Fairfax might occur as a result from this starting point:

1. That insurance rates could increase post these losses
2. That Fairfax can write more business than it has in the past due to it having significant excess statutory capital.

These points and others are laid out in the Fairfax annual letter – the link to which is here: http://s1.q4cdn.com/579586326/files/doc_financials/2017/annual/WEBSITE-Fairfax-Financial's-Shareholders'-Letter.pdf

Just the type of compounding machine we look for

We extract the relevant sections for you below from the annual letter. We remain of the view that a 15% growth in Book Value per Share is more achievable than Mr Market thinks due to the power of negative cost float. Helpfully Prem observes in the letter a point we have been making to investors, i.e. that Fairfax only needs a 7% ROI (Return on Investment) to achieve his started target of 15% annual growth in book value. The balancing item being a 95% combined ratio – or looked at another way a 5% negative cost of float. The working of this low risk gearing is laid out in our earlier notes attached. For us Markel Corporation remains the interesting yardstick for Fairfax's future valuation. In its case Mr Market, impressed with its recent achievements in franchise investing, has put the shares on 1.8x book value. Were Fairfax shares that today trade on c.1.0x book value to end the next 5 years at 1.4x book having achieved its compounding of Book Value at 15% pa then an investor buying the shares today might expect to make an IRR of closer to 18% pa (see attached spreadsheet). That is a compounding machine we are very keen to hitch a ride on. Extracts of the annual letter are below.

Value per share the Teledyne way

We note the close understanding of per share value discussed in this section. Prem outlines that whilst the companies' shares in issue since inception has risen 5.6x common equity is up 1000x. The clear commitment to follow the Teledyne model then follows – committing to do so for ten years.

As you can see, while this acquisition increased our gross premiums, investment portfolio and common equity by about 30%, our shares outstanding grew by only 22%. Although we issued the Fairfax shares at a 6% premium to book value while we purchased Allied World at a 32% premium to book value, we are confident that the high quality of Allied World, let by Scott Carmilani, will make this an excellent acquisition for us, but we were not pleased at issuing our shares at only a 6% premium to book value.

The table below shows the shares we have issued and retired over our history:

	Shares Issued	**Shares Repurchased** *(shares in millions)*	**Shares Outstanding**	**Reason for Issue**
1985			5.0	
1986-90	2.3	1.8	5.5	Morden & Helwig
1991-95	3.8	0.4	8.9	Hamblin Watsa/Ranger/Lombard
1996-00	5.3	1.1	13.1	OdysseyRe/Sphere Drake/Crum & Forster/TIG
2001-05	5.5	0.8	17.8	Financial soundness
2006-10	4.3	1.6	20.5	Zenith/OdysseyRe minority
2011-15	2.2	0.5	22.2	Brit
2016	1.0	0.1	23.1	ICICI Lombard/Eurolife
2017	5.1	0.4	27.8	Allied World
Total	29.5	6.7	27.8	

Over our history, we have issued 29.5 million shares as we expanded Fairfax from net premiums written of $10 million to $10 billion (current run rate of $11.5 billion). During this period, we have also reduced our shares outstanding by 6.7 million, for a net increase of 22.8 million. As the table below shows, our shares outstanding have grown by 5.6x while net premiums written, investments and common equity have increased by 1,000x or more. Henry Singleton, at Teledyne, reversed this trend, as you know, and over the next ten years we expect to do the same – use our free cash flow to buy back our shares!

	1985	**2017**
Net premiums written	10	9,984
Net earnings	(1)	1,741
Investment portfolio	24	39,255
Common shareholders' equity	8	12,476
Shares outstanding *(millions)*	5.0	27.8

To view the remainder of this in-depth report, please contact Andrew Hollingworth, Andrew@hollandadvisors.co.uk for a complete PDF copy.

Disclaimer

This document does not consist of investment research as it has not been prepared in accordance with UK legal requirements designed to promote the independence of investment research. Therefore even if it contains a research recommendation it should be treated as a marketing communication and as such will be fair, clear and not misleading in line with Financial Conduct Authority rules. Holland Advisors is authorised and regulated by the Financial Conduct Authority. This presentation is intended for institutional investors and high net worth experienced investors who understand the risks involved with the investment being promoted within this document. This communication should not be distributed to anyone other than the intended recipients and should not be relied upon by retail clients (as defined by Financial Conduct Authority). This communication is being supplied to you solely for your information and may not be reproduced, re-distributed or passed to any other person or published in whole or in part for any purpose. This communication is provided for information purposes only and should not be regarded as an offer or solicitation to buy or sell any security or other financial instrument. Any opinions cited in this communication are subject to change without notice. This communication is not a personal recommendation to you. Holland Advisors takes all reasonable care to ensure that the information is accurate and complete; however no warranty, representation, or undertaking is given that it is free from inaccuracies or omissions. This communication is based on and contains current public information, data, opinions, estimates and projections obtained from sources we believe to be reliable. Past performance is not necessarily a guide to future performance. The content of this communication may have been disclosed to the issuer(s) prior to dissemination in order to verify its factual accuracy. Investments in general involve some degree of risk therefore Prospective Investors should be aware that the value of any investment may rise and fall and you may get back less than you invested. Value and income may be adversely affected by exchange rates, interest rates and other factors. The investment discussed in this communication may not be eligible for sale in some states or countries and may not be suitable for all investors. If you are unsure about the suitability of this investment given your financial objectives, resources and risk appetite, please contact your financial advisor before taking any further action. This document is for informational purposes only and should not be regarded as an offer or solicitation to buy the securities or other instruments mentioned in it. Holland Advisors and/or its officers, directors and employees may have or take positions in securities or derivatives mentioned in this document (or in any related investment) and may from time to time dispose of any such securities (or instrument). Holland Advisors manage conflicts of interest in regard to this communication internally via their compliance procedures.