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Fairfax Financial, Ltd

FFH (US: NYSE / Canada: TSE)

Update as of June 9th, 2009

Current Price: ~$256.91/share

Company Report Update:

The nice thing about managing money professionally is that what you say is public and you are held accountable to what you claim or any estimates you make. As I sat down to update the investment summary on Fairfax I felt a little nostalgic reading back over the report I originally wrote more than 18 months ago. I concluded the report (from December of 2007) just as the financial sector of the economy really started to melt down in earnest with the following:

> *"As I write this, Fairfax is speeding ahead producing good results in a tough environment and is in an enviable situation of having a lot of free cash on hand and a secure financial footing just when other North American financial companies are seeing a fall from grace. In the world of investing, this is by far the most exiting of times; to be able to buy when others are desperate to sell is a wonderful thing. The fact that the team at Fairfax has the knowledge, discipline, experience, and patience to make the most of it makes me very unwilling to sell shares in this company at anywhere near the current prices."*

At the time Fairfax had a net equity value of $204/share (~$3.6B) and I was clearly predicting boom times ahead for the company. Looking at my previous remarks today I (somewhat surprisingly) find myself completely agreeing with what I said. Virtually everything I thought would happen has happened. The financial meltdown proved to be a huge boon to Fairfax, and the company is sitting pretty while a chunk of the competition in their sector has been obliterated. The companies' net equity value per share has moved from $204/share at the end of Q3 '07 to (my estimate) roughly $290/share as of June of 2009. That is an increase of 42% in less than 2 years during the most brutal economic environment in a long time…

… and the stock is down more than 15% during the same time.

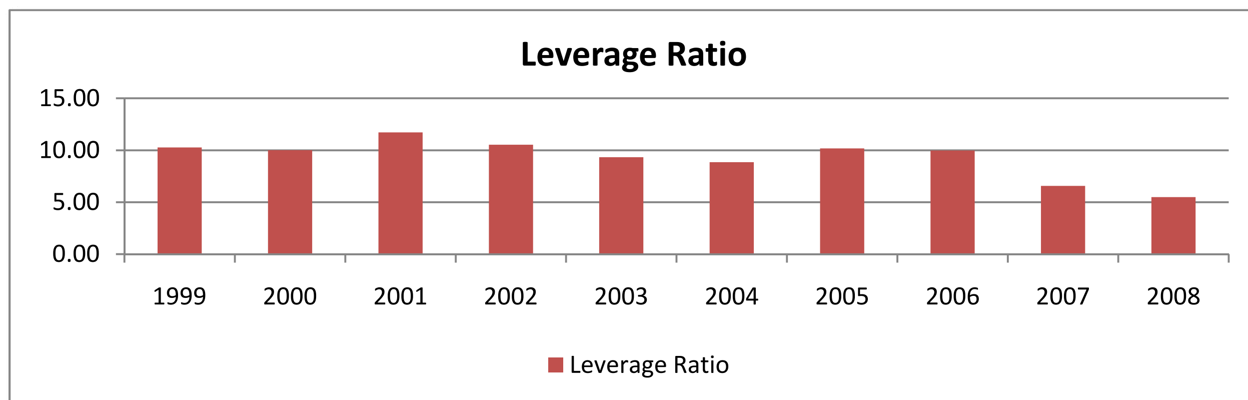
This kind of thing is what makes some market watchers and even seasoned investors go insane. While the future is still very bright for Fairfax, you can now purchase each dollar of equity in Fairfax for $0.88 on the dollar where in December of 2007 you had to pay $1.45 for each dollar of equity you received. While I was not an active purchaser of Fairfax shares in 2007 anywhere near $297, I didn't think that it was an unreasonable price. I was not interested in selling then as I felt fair value was still a bit higher. I was clearly right about the near future of the business, but I did not (and could not) predict the price at which the market would pay me for my shares even nearly two years into the future.

Now to be fair, much has changed in the insurance world since my original report. Average valuations for insurance companies have come down from roughly 1.6 times equity to 1.0 times equity. Clearly the market has changed its mind about what insurance companies are 'worth' and Fairfax's share price has been affected. In the long run Fairfax's returns will be driven by business performance, but in the short term the stock price movement weighs very heavy.

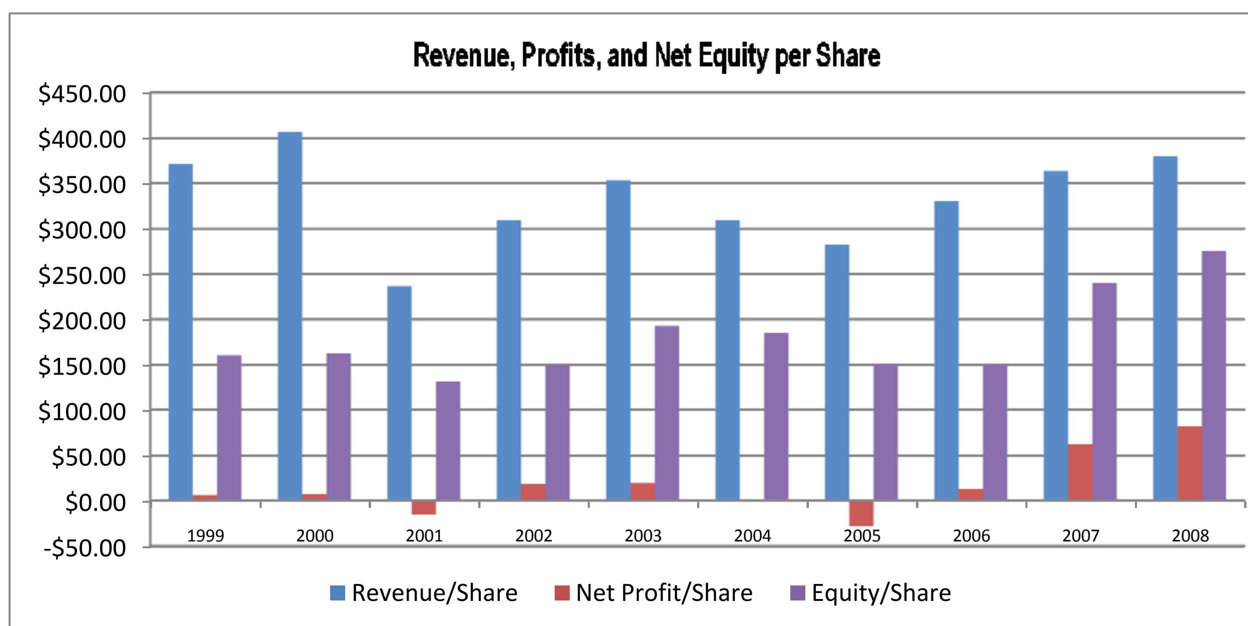
Below I've updated the financial information that I presented in my original report to show the drastic financial improvement that was a long time coming for the Fairfax team given their hard work and what they went through over the past ten years. I've included the key financial information for from 1999 to 2008 which summarizes the beginning of the long period of tribulation with the company (the lean seven years) to show how the company not only survived their biggest challenge(s) as a company but even thrived during a stretch of time where many companies struggled mightily to produce positive returns.

The first chart shows the leverage ratio which is a simple calculation of assets divided by equity. When Fairfax ran into problems in the late 90's they quickly ran into issues with their liability levels and overall leverage levels. After

struggling with this issue throughout the first half of the decade by selling stock to raise money and refinancing their loans, progress finally was made in 2007 and 2008 and the leverage ratio has been brought down below six recently which is more in line with the level of leverage Fairfax employed in the mid 90's.



The next chart shows Fairfax's revenues, and income (per share) generated each year and also the overall net equity (book) value (per share) the company held at the end of each year. While the company has shrunk revenues overall over the past 10 years, profitability was positive on average and has ramped up recently quite nicely. From the end of 1999 to the end of 2008, book value per share has risen from ~$160/share at the end of 1999 to $275/share at the end of 2008 (and $290 as of June '09 per my estimates). This increase amounts to the company growing their equity value by about ~7% per year. Certainly not an amount that will turn many heads, but given the fact that this was a very difficult period in a long time for many companies (and Fairfax in particular), I think the 7% should not be dismissed.



I want to call special attention to the final two years in this chart. The profits reported in each year were greater than $50/share and more than $75/share in 2008. It was only five years prior when Fairfax stock traded for only $75/share! Fairfax is that rare company that is willing to do the right and conservative thing even in the face of extreme challenge and adversity. The rewards recorded in 2007 and 2008 were for the most part the result of actions taken years before in preparation for difficult times that inevitably come. Successful investing requires patience to wait out the craziness of the crowd as you wait for your various bets to pay off. Patience is rewarded, but the timing is always uncertain.

As I reflect on the decisions that Fairfax has made in the recent past, I see a common thread which provides a great lesson:

1) 2005-2008 → Fairfax was actively purchasing insurance on the default of dozens of financial institutions in the US and overseas (including Countrywide, AIG, WaMu, and many others).
2) 2005-2008 → Fairfax was actively hedging their stock portfolio to protect nearly 100% of their portfolio from a possible meltdown in the broad US stock market.
3) June 2008 → Fairfax increased their bets against energy companies as they saw the economy deteriorating drastically and oil and gas prices were still near their all time highs.
4) Q3 2008 → Fairfax held the vast majority of their bond portfolio in direct government guaranteed debt and also added to their bets that government debt would rally strongly right before the cliff dive in economic activity took place.
5) November 2008 → After the drastic market collapse of stocks and the incredible rally of government debt, Fairfax un-hedged their stock portfolio and sold the majority of the government debt to buy municipal and corporate bonds that had been dumped indiscriminately by other investors who were then eager to buy government debt (at record low yields) for "safety".
6) Q1 2009 → Despite another severe leg down in the stock market, Fairfax began loading up on blue chip stocks of companies like Dell, Johnson & Johnson, Pfizer, Intel, Wells Fargo and Kraft.
7) 2003-2008 → Despite the unending desire from Wall Street for companies to ***grow*** Fairfax shrank their net insurance premiums in 2008 to a level just below that of 2003. They did this because insurance is about pricing risk (just like investing) and the recent prices for insurance have not on aggregate been satisfactory. When other insurers wake up to the bad decisions (and losses) they have been generating by writing insurance at unduly low prices, Fairfax will be ready with capacity for their customers, but only when the price is right.

As I sit here and marvel at how well Fairfax prepared and profited from this once in a generation event, I can only sit back and smile at the common thread of all these decisions: They were all fairly unpopular ***at the time they were made***. While going against the crowd just for the sake of it is never a wise idea, there will always be times at which a bold and contrarian bet can be very profitable. Fairfax has a 25 year history of making bold and contrarian bets at times when the odds are heavily in their favor. While I can't say what will transpire over the next two or five years at Fairfax, I'm confident that on average the decisions made by managers both on the insurance and investing sides of the business will be the right ones.

Nothing in life or investing is guaranteed, but when you can buy a shareholder friendly company for less than its book value that has a history of growing book in good times and bad at above average rates, I think that is a great opportunity.

(The original investment report on Fairfax Financial Ltd is included below in its entirety)

NOTE: Benjamin Hacker (personally and through his partnership) and clients of Remick Capital, LLC owned shares of Fairfax Financial, Ltd or that of its subsidiary Odyssey Re Holdings at the time of this writing. This is not an offer to buy or sell securities. Each individual's investment situation is different, and not all investments are suitable for everyone.

Fairfax Financial, Ltd

FFH (US: NYSE / Canada: TSE)

Report as of December, 17th 2007

Investment Success

Purchases: May 2005 @ ~$135/share; July 2006 @ ~$97/share; Summer 2007 @ $185-195/share
Last Sale: None
Current Price: ~$297/share

All prices are in US Dollar (USD) unless otherwise stated. Fairfax is a Canadian based company so all financial numbers are translated to USD for clarity.

Company Background:

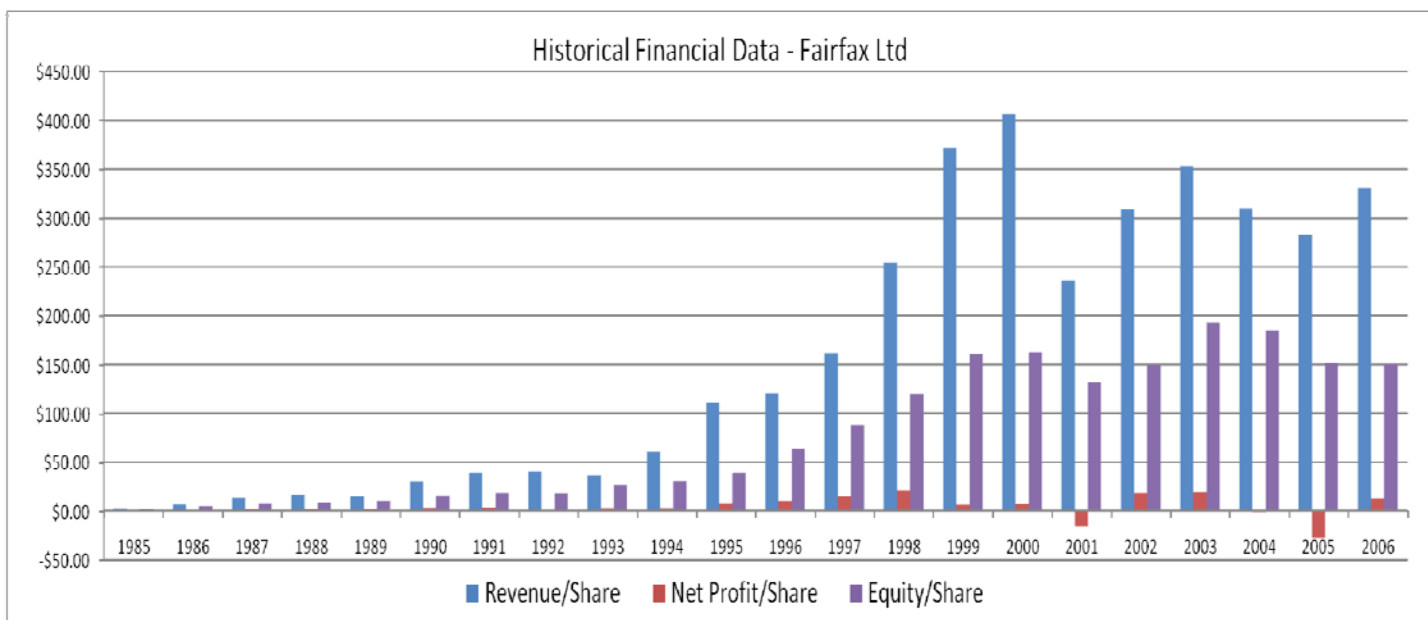
Fairfax Financial is an insurance holding company based out of Canada. The company was put under current management in 1985 when V. Prem Watsa took control of Markel Financial (this was the company that later became Fairfax). Over the ensuing 15 years Watsa compiled a team of strong managers and utilized the corporate insurance structure as a leveraged investment vehicle to buyout troubled insurance companies and turn them around. The process was phenomenally successful for Watsa and his team until a pair of bad acquisitions in the late 90's put the company into a very tight financial situation.

The leveraged (use of significant debt) nature of Fairfax's acquisition strategy made things very profitable when investments went well, but also added serious risks. At the peak of Fairfax's success in 1999, the company had compounded it's equity per share by greater than 30%/year for 15 years and some in the media began to refer to Watsa as the "Warren Buffett of the North". As a consequence of this strong success, expectations were high, and the hard times that Fairfax entered following the 90's was quite a contrast for the business and its shareholders; and very dark for the share price.

Off a share price high of over $600(CAD) per share in 1999 Fairfax began to tumble. From 1996 on Fairfax had been on an acquisition spree that was tough to digest. Problems finally surfaced with the acquisition of TIG. It became clear that Fairfax bit off more than it could chew and would need several years to work through the losses and restore their financial situation. Then came 9/11; it was a devastating blow to many insurance companies and especially those with weakening financials and heavy debt burdens.

The situation for Fairfax was perilous and the debt rating agencies began to downgrade Fairfax bonds. Articles began to come out about how Fairfax would need to raise capital to shore up their balance sheet and pay their debts. Also, skeptical short sellers 'shorts' (people who bet that prices of particular stocks will decline) began to sell Fairfax shares at an impressive clip. Many reports came out questioning Fairfax's recorded equity (book) value as being inaccurate or even fraudulent. Questions were also raised about the company's ability to its debts. During this prolonged period of trouble, Fairfax was forced to jettison portions of two subsidiaries by IPO to raise cash (Odyssey Re Holdings in 2001, and Northbridge Financial in 2003). Both subsidiaries were sold at very low prices due to the weak financial position that Fairfax was in at the time.

In 2003, at the height of uncertainty, Fairfax's shares hit a low of $50/share in New York trading. Later that year, Fairfax's investment team achieved tremendous gains in the investment portfolio through a very large investment in very long duration bonds (when long terms rates go down, these kinds of bonds can rise in price dramatically); as bond interest rates dropped surprising many market pundits as well as the Fairfax shorts.



For the next few years, Fairfax continued working through the uncertainly as more and more articles and investors began to question their business, investment successes, integrity, accounting, and all areas of the company. Fairfax began to slowly improve its financials while still working through the terrible acquisitions they made in the late 90's. Then, in 2005, hurricane Katrina ruptured the levy in New Orleans causing one of the most massive disasters in the history of North America. As Fairfax is at its heart, an insurance company, this disaster put a huge dent in its finances once again. Fairfax was forced to raise new equity capital at a price below book value; diluting existing shareholders' ownership.

Investment Thesis:

Insurance companies at their heart, have a fairly straight forward business model. They offer, for a premium, coverage for certain events (fires, disasters, house fires, auto accidents, or any number of things you can put into a contract. These events can span from the short term (aka 'short tail') such as auto-insurance, to the long term (aka 'long tail') such as life-insurance; and everything in between. But for every insurance company, the core business can be thought of as two pieces:

1) *Underwriting:* Pricing and charging for the specific risks that are covered under an insurance policy.

2) *Investing:* Investing the premiums (aka 'float') that are received now from customers to make a profit on them before they are required to be paid out for claims.

In order for an insurance company to be successful, it should be doing both of these things well… both charging the appropriate rates for its policies and also investing the float to make good returns while it holds the float today.

Throughout the company's history, Fairfax had very successfully executed on both of these parts of their business, but in the recent history the underwriting aspect was doing very poorly due to both the poor acquisitions that they entered into and the 'unexpected' (i.e., likely mispriced) events that took place after the turn of the millennium.

Why was the Stock so Cheap?

As explained above, Fairfax had essentially no positive news over a nearly 5 year period. While Fairfax had a proven management team and investment track record; these things were easy to forget as an investor when you don't see any results for a span of several years. For all intents and purposes, there were only a few loyal shareholders who were still interested in following Fairfax, much less investing in its shares. Due to the lack of interest and in some cases pure disdain, Fairfax became the ultimate dog stock; no one wanted to own it.

The upside to this kind of situation is that the price you have to pay for these kinds of companies is unduly low… sometimes ridiculously so. In May of 2005, when I made my first purchase into Fairfax, the company was being valued in the market at a price to book ratio (the ratio of current share price to equity/share) of ~0.70x. The market was saying that Fairfax was in fact going to destroy value in future. It was in effect trading at a discount to liquidation value.

Afterwards the stock bounded higher but then the Katrina/Rita disasters unfolded the following year. Fairfax's shares began to sink again. Slowly at first, but after a few months, they went into a free fall. After they issued more shares to shore up their finances (again), Fairfax traded all the way down to $90/share in 2006 and traded for a price to book value of less than 0.60x. (As a yardstick, the insurance industry on aggregate in the US traded at a multiple to book of roughly 1.70x at this time – a premium of almost 200%).

2006 was a scary time for shareholders of Fairfax. Coming off two bad hurricanes, and years of losses, investors were forced to look forward and see whether they wanted to own Fairfax for the ***future***. Many of them voted with their feet and sold.

Moving forward into 2007, the story had changed quite a bit. The company had patched what are hopefully the last of its major financial issues due to a very weak hurricane season (which allowed it to build up a lot of cash) and at the same time the investment portfolio that had for so long been positioned very conservatively began to show some results as the US economy began to weaken. While the shares were up 100% since the bottom in 2006, they were certainly not up to what I thought they were worth. So Buying in 2007 at around $190/share was a different situation (more certainty, but less reward potential), but was still a good bargain in my opinion.

Laying the Concerns to Rest:

Fairfax would normally be a company that I would walk away from due to the complexity and shadowiness surrounding them. However, there were a few facts when taken together made me dig further and further… and I liked what I saw.

1) The CEO controlled the company via a 9% ownership stake, but a >40% voting stake (through a special class of stock that is not available publicly). ***However,*** he had essentially aligned his entire net worth with his ownership of FFH stock and he had a solid history of treating shareholders well. Many years earlier he had sold his investment company to Fairfax (at a very fair price) and had most of his net worth in the shares he owned of Fairfax. His salary, while 'high' by layman's standards, was ~$500k which is moderate for a large insurance firm on Wall Street.

2) The senior management team while being beset by frustrated investors, vocal short sellers, skeptical rating agencies, and questionable corporate tactics from those who felt they were frauds, had remained entirely the same during this period of tribulation. There were no defections, no firings, no one moving on to 'pursue other interests' or 'spend more time with their families'. The entire team just put their nose to the grind stone and kept working towards the goal of turning the company around and prospering.

3) The long time investment team at Fairfax had a member who also ran his own mutual fund company (Francis Chou). Since his employment at Fairfax (which began in 1987), this manager accepted *zero* salary and bonus to avoid any appearance of conflicts or impropriety. One rule I have is that whenever someone works for free (no cash, bonus or options…); you should pay attention as there is likely something special going on.

4) One of the most prevalent (to the point of being axiomatic) sentiments from investors about Fairfax was that the saving grace of the company was ***only*** its investment team. The belief was that Fairfax was a sub-par (or worse) insurance underwriter, and the only reason it was still in business was because the investment team kept pulling rabbits out of their collective hat. (These same skeptics also claimed that the investment team really wasn't that good, but we'll forgive them for their confusion). The interesting thing about this is that Fairfax's insurance prowess was being clouded by those poor acquisitions in the late 90's. They had consistently shown the ability to instill underwriting discipline at the subsidiaries that had been with them longer. Their Northbridge subsidiary was a stellar example of this.

5) On top of all this, the valuation placed on Fairfax assumed the worst was going to transpire. ***Any*** positive news would help to push the price higher. When you can buy a profitable insurance company with good management for <0.75x book value, you can tolerate a lot of bad news and still make good money.

6) Finally, specifically to the purchase(s) that was made in 2007, there was an additional piece of information that was important but not widely known. Fairfax had purchased in aggregate roughly $200-300m worth of Credit Default Swap (CDS) protection on various US financial institutions over the past years. This is just a fancy way of saying that Fairfax bought insurance policies on event of default (think bankruptcy) of several US financial companies (Countrywide, Washington Mutual, and several others). This kind of policy is purchased for pennies on the dollar, and usually ends up being worthless because these kinds of companies rarely default, but Fairfax reasoned that the insurance was so cheap, that it made sense to make the bet *just in case* the US financial system ran into trouble. As everyone is now aware, this very thing happened in 2007 and is still unfolding as I write this. At this time, the value of Fairfax's default insurance policies is now up roughly $800m and counting. While none of the institutions have gone bankrupt yet, the *probability* (or perception) of default has increased dramatically, and this has made Fairfax's insurance policies very valuable should they choose to sell them for a gain.

Conclusion:

The length of this report speaks to the complexity of an investment in Fairfax or any of its subsidiaries. There are many moving parts to their business, and there is a lot of history to be familiar with before getting comfortable enough to invest. (I followed the company reasonably closely for 2 years before I invested.) With that said, the same things about Fairfax that make it hard to understand, and potentially overwhelming to many investors is what makes it possible at certain times to buy the shares for prices that are much less than the worth of the company. I believe this same trait will allow us as shareholders at some point in the future to sell the same shares for far more than the worth of the company… but that is just my own speculation.

As I write this, Fairfax is speeding ahead producing good results in a tough environment and is in an enviable situation of having a lot of free cash on hand and a secure financial footing just when other North American financial companies are seeing a fall from grace. In the world of investing, this is by far the most exiting of times; to be able to buy when others are desperate to sell is a wonderful thing. The fact that the team at Fairfax has the knowledge, discipline, experience, and patience to make the most of it makes me very unwilling to sell shares in this company at anywhere near the current prices.

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