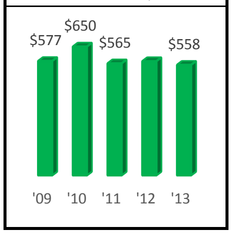
SELECTIVE WEALTH MANAGEMENT

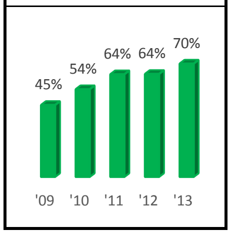
Lancashire Holdings
July 9, 2014

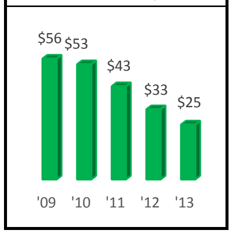
General Overview

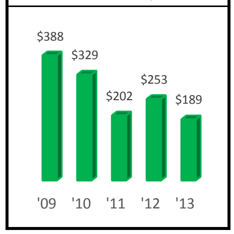
Lancashire Holdings Limited ("LCSHF") is an insurance company headquartered in London, England. The company writes insurance policies for large and obscure risks such as marine cargo, terrorist attacks, cruise lines, and super catastrophes. These various product lines are very difficult to accurately price and companies that can price these risks appropriately have the ability to earn large profits. Since the company's inception Lancashire has been in a league of its own when pricing risk conservatively and accurately.

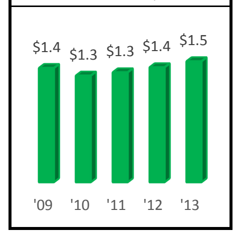
Net Premiums	Combined Ratio	Investment Income	Owner Earnings	Shareholder Equity
$557,600,000	70.3%	$25,400,000	$189,400,000	$1,460,400,000
5-Year AVG = $585M	5-Year AVG = 59%	5-Year AVG = $42M	5-Year AVG = $272M	5-Year AVG = $1.35B











Purchase Logic

LCSHF is one of the world's most prestigious and successful insurance operations. For more than half a decade the company has lead the industry with the best combined ratio in the industry. In the last 5 years the company averaged $272 million in net income and paid out the majority of these earnings as dividends. We made our purchase at $10.71 USD per share which equates to a market capitalization of $2.02 billion. We effectively paid 7.5x the average earnings of the business.

We calculated the price to earnings ratio based on average earnings because of the nature of the insurance industry. During years when there are no natural disasters and the market is 'hard' Lancashire has the ability to earn more than $380 million dollars. When natural disasters occur with greater frequency and severity losses mount up and LCSHF may post a slight loss. This is the nature of the insurance business – and a calculation using average earnings is the appropriate way to value the purchase of any insurance firm.

This incredible purchase price was available to us due to the general market conditions of the insurance industry during 2014. The industry is currently in a 'soft' cycle, meaning there are too many companies with too much capital attempting to sign up customers. This has the natural effect of driving down prices and reducing profits for the industry as a whole. This soft cycle exists due to the ultra-low interest rate environment and rising stock market – investors are looking for places to earn reasonable returns on capital and money is flooding into the insurance business. These types of soft cycles typically end when a series of natural disasters occur eliminating companies that have underpriced the risk associated with the insurance they write. As these weaker companies disappear the market 'hardens' allowing prices to rise and profits to increase. When the soft cycle ends LCSHF will be well positioned to benefit from the increasing prices.

While we wait for the market conditions to improve we anticipate collecting annual dividends from LCSHF ranging from 5% to 15% depending on the profits earned in any given year. This annual dividend rate is sensational when compared to US treasuries at 2%, bonds at 3-4%, or even junk debt paying approximately 5.5%. Given the exceptional quality of LCSHF's insurance business and the high dividend payout this investment should yield satisfactory results over time.

Key Drivers

The key metrics for the business are net premiums, the combined ratio, investment income, owner earnings, and shareholder equity. Each metric is briefly described below.

<u>Net Premiums</u>

When an insurance company charges a customer for a policy this is known as a premium. The premium collected is typically used to pay for underwriting expenses and actual losses that occur under the insurance contract. Companies as large as LCSHF typically purchase reinsurance on a portion of the risk they assume and pay the reinsurer a portion of the initial premium. The premium that remains is known as a 'net premium' and is a measure of the total business written by an insurance company during a fiscal year. This is similar to revenue for most operating businesses.

<u>Combined Ratio</u>

An insurance company incurs expenses in two categories: Underwriting expenses and Loss Expenses. The underwriting expenses are salaries, wages, and commissions paid to insurance brokers and actuaries. The loss expenses are losses paid out to policy holders when insurance claims are made. A combined ratio is calculated as follows:

$$Combined\ Ratio = \frac{Underwriting\ Expenses + Loss\ Expenses}{Net\ Premiums}$$

If the net premiums are greater than the expenses the insurance company will earn a profit and the combined ratio is less than 100%. If the inverse is true then the insurance company losses money and the combined ratio is greater than 100%. Profits earned by having a low combined ratio are known as underwriting profits.

<u>Investment Income</u>

Investment income is earned on insurance 'float' – or the money held by an insurance firm that has been collected by customers, but has not yet been paid out to policies holders for accidents that will likely occur at a later date. The investment income earned from insurance float is an integral part of most insurance operations and allows companies to earn large profits even if the combine ratio is equal to 100%.

<u>Owner Earnings</u>

The owner earnings for LCSHF can be calculated by adding the profits earned from underwriting and the investment income. This metric is the most important for the shareholders of the business. Lancashire typically pays out all owner earnings each year in the form of a special dividend. These special dividends have been extremely substantial for all shareholders in the last 5 years.

<u>Shareholder Equity</u>

In order to write insurance policies LCSHF requires a certain amount of equity to ensure they can pay claims from policy holders. As the business grows more equity is required to write more policies. LCSHF has a stated objective of earning a return on shareholder equity that is equal to the LIBOR interest rate + 13.5%.

Historical Performance of Key Metrics

Year	'09	'10	'11	'12	'13
Net Premiums	$577,100,000	$649,900,000	$565,100,000	$576,100,000	$557,600,000
Combined Ratio	44.60%	54.40%	63.70%	63.90%	70.30%
Investments	$1,892,500,000	$1,718,900,000	$1,713,400,000	$1,874,600,000	$2,016,000,000
Investment Income	$56,000,000	$53,400,000	$43,200,000	$32,500,000	$25,400,000
Equity	$1,379,100,000	$1,286,900,000	$1,326,800,000	$1,387,700,000	$1,460,400,000
Owner Earnings	$388,200,000	$328,600,000	$201,600,000	$252,700,000	$189,400,000

Net Premiums

Historically the net premiums written for LCSHF have been relatively stable. This means that the business has remained roughly the same size for the last 5 years. Management has clearly stated that the objective of the company is to earn large returns on equity, LIBOR + 13.5%, and pay those dividends out to shareholders annually. When all profits are paid to shareholders the equity base cannot grow and net premiums cannot increase. It is our expectation that net premiums remain relatively stable for the next 10 years and profits are paid to shareholders rather than to grow the business.

Combined Ratio

LCSHF is unique in the world of insurance. Most insurance firms underwrite with a combined ratio of roughly 100%, meaning they earn no profits on the premiums they collect. Instead, these insurance companies invest the premiums collected to earn the majority of profits through investment income. However, LCSHF earns the majority of all profits from underwriting and has one of the best combined ratios in the world. In the last 5 years LCSHF has posted an average combined ratio of less than 60% - truly an incredible record. The combined ratio for LCSHF will be lumpy moving forward depending on the frequency and severity of natural disasters in regions they insure. Over a long period of time – 10 year or more – we expect LCSHF to maintain a combined ratio of less than 70% and continue to post sensational profits.

Investment Income

In the last 5 years the investment income for all insurance companies has been steadily declining. The ultra-low interest rate environment has made it exceedingly difficult to earn acceptable investment income. Fortunately for LCSHF investment income only contributes slightly to the company's overall profitability due to the phenomenal combined ratio. LCSHF independence from interest rates will allow the company to continue to pay large dividends to shareholders even if interest rates remain low. In the event that interest rates rise in the future the investment income would increase, but this condition is not necessary for LCSHF to be a sensational investment.

Owner Earnings

In the last 5 years LCSHF has averaged owner earnings of $272 million. Historically the company has paid out all earnings at the end of each year as a special dividend. This has provided steady income and wonderful investment returns for owners of LCSHF over the last 5 years. It is our expectation that the owner earnings will be very lumpy in the next 10 years, but on average will be approximately the same as the previous half decade.

Shareholder Equity

LCSHF maintains an equity base between $1.3 billion and $1.5 billion to allow the company to underwrite policies for clients. We anticipate the company continue to payout the majority of earnings as a special dividend and for the equity base to remain relatively unchanged for the next 10 years.

Summary of Key Metrics

Metric	Expectations
Net Premiums	Fluctuate between $500 million and $700 million Average of $600 million over 10 years
Combined Ratio	Fluctuating between 50% and 130% Average of 70% over 10 years
Investment Income	Fluctuate between $25 million and $80 million Depends on interest rates
Owner Earnings	Fluctuating between a slight loss to $350 million Average of $275 million over 10 years
Shareholder Equity	Fluctuating between $1.3 billion and $1.5 billion

The Moat Around The Metrics

Most insurance companies operate in a price competitive environment where customers are interested in paying as little as possible to obtain an insurance policy. The business LCSHF operates is slightly different. Due to the large size and unique nature of the policies LCSHF insures customers tend to be less price sensitive and more concerned about the insurance providers capacity to pay in the event of disaster. As one of the world's most prestigious insurance firms LCSHF has developed a reputation for excellence and trust. Customers are more comfortable doing business with LCSHF due to the long standing success of the company and a long history of fulfilling past insurance obligations.

In addition to an excellent reputation in the industry LCSHF also benefits by having a team of the best underwriters in the world. Insuring obscure risks is complex and difficult. The team at LCSHF has been able to conservatively and accurate price risk on some of the most complex policies ever written. The sensational underwriting at LCSHF has earned shareholders outstanding profits since the company's inception. We believe these talented underwriters and the culture of excellence will allow LCSHF to continue posting industry leading combined ratios long into the future.

Risks

As an insurance firm LCSHF carries more risk than an average business. Below is a brief summary of the risks we've assumed as owners of LCSHF.

<u>Short-Term Risks</u>

- Low Interest Rates. In the event that the current low interest rate environment continues for an extended period of time it will have an impact on LCSHF's ability to generate investment income. As investments mature and are reinvested at lower interest rates investment income will remain depressed for the foreseeable future. We view this as a low risk event due to the fact that LCSHF earns the majority of profits from underwriting and not from investment income.
    - Low Risk
- Insurance Industry Soft Cycle. The insurance industry is presently in the midst of a soft cycle characterized by low pricing and excess risk taking by market participates. This soft cycle has forced LCSHF to lose customers due to inadequate pricing on policies. If the soft cycle persists for several years it could have a material impact on LCSHF ability to generate underwriting profits and pay dividends to shareholders. The soft cycle will likely end when the severity and frequency of disasters returns to more normalized levels.
    - Moderate Risk

Long-Term Risks

- Large Losses on Policies in Force. In any given year there is the potential that several large policies will simultaneous experience abnormally large losses. This is both a short-term and long-term risk for the business. In the short-term profits would be materially impacted, as expected, but over a longer period of time would normalize to an average profit per year of roughly $272 million. In the long-term there is always the risk that several disasters of extreme size could occur simultaneous and render the business insolvent. We view this risk as extremely low as LCSHF typically will not write policies they cannot afford to pay. When pricing risk LCSHF considers exceptionally rare events – those that occur once every 250 years – to ensure adequate pricing.
    - Moderate Risk
- Investment Risk. During the financial crisis of 2008 and 2009 many insurance firms experienced large losses on fixed income investments related to the housing sector. When insurance firms experience large losses on the investment portfolio there is a possibility that the company would no longer be able to payout claims on insurance policies previous written rendering the business insolvent. We view this as very low risk because LCSHFs' investment portfolio is much safer (and yields less) than almost any competitor. The business invests in only the highest quality bonds and does not have material exposure to any risky asset classes. The low investment income from this conservative approach is compensated for by the outstanding underwriting profits earned each year.
    - Low Risk

Conclusion

We purchased LCSHF at an attractive 7.5x average earnings due to the insurance industry being in a soft cycle. This soft cycle will reduce profits for LCSHF in the near future, but we fully anticipate other industry players to disappear when the frequency and severity of super catastrophes increases to historical levels. At this time the market will improve and LCSHF will begin to earn above average profits. While we wait for the market conditions to improve we will be able to collect annual dividends payment from LCSHF ranging from 5% to 15%. This level of dividend payment is far in excess of any investment alternatives. We are delighted to own one of the world's best insurance operations at such an attractive price.

Works Cited

1) *LCSHF Annual Report - SEC Filing 20-F.* EDGAR, 2013.

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