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Requiem for a Heavyweight, part 3

Buzzards Circle Reliance

IN HIS 1958 FILM-NOIR classic, Touch of Evil, *Orson Welles plays Hank Quinlan, a corpulent, corrupt detective in a sleazy border town. Toward the end of the film, the bloated, alcoholic Quinlan visits Tanya, a fortune-telling madam of a whorehouse he used to frequent.*

"Come on, read my future for me," Quinlan says.

"You haven't got any."

"What do you mean?"

"Your future is all used up."

WITH EACH PASSING DAY, Reliance Group Holdings bears a greater resemblance to the doomed Hank Quinlan; its future is all used up. Reliance Group is increasingly at odds with its world, like a character trapped in the Twilight Zone. Although it is ill, it can't get a doctor to make a house call. Only an undertaker (Leucadia National) will monitor its pulse.

In an insurance market where even "good" business, written by insurers whose financial strength is not in doubt, can be frightful, Reliance has written business of particularly dubious quality. (Last week *The Wall Street Journal* reported that Reliance was on the D&O for Unistar Financial, a hyped-up auto-insurance stock we exposed last year, and whose shares subsequently collapsed from $41\frac{5}{8}$ to $\frac{3}{4}$.)

Since last August we've written about Reliance time and time again. After all, it isn't every day that one foresees the downfall of a large property-casualty empire whose roots date to 1818. The titles of some of our articles are revealing: "Reliance: Will Raters Pull the Trigger?"; "Reliance Group's Troubled Debt"; "Bonds Plunge: Prices Imply Default"; "Dividend Cut?"; "Reliance's Group's Day of Reckoning"; "Night of the Living Dead?"; "Unicover: Can Cedants Collect from Reliance?"; and "Reliance Insurance Company on the Brink: Ratings too High."

We've been writing about Reliance Group and its chairman Saul Steinberg since March 1992, and over the years we've had a hard time finding many positive things to say. Our first article, which noted our concerns about Reliance's leverage, debt, and corporate structure, was titled, "Would You Buy a Used Car from This Man?"

On May 26, 2000 Reliance Group and Leucadia National issued a joint press release bearing the headline: "Leucadia and Reliance Enter into Agreement for Leucadia to Acquire Reliance." The text, which said little, did say that under the terms of the "proposed transaction," Reliance's shareholders would receive 0.11059346 shares of Leucadia for each share of Reliance stock they owned.

The press release also said that Reliance had granted Leucadia an option to purchase 9.9% of the company, and that "holders of approximately 33% of Reliance's outstanding common stock" (the Steinbergs, one presumes) had agreed to vote for the transaction and had granted Leucadia an option to acquire their shares for $2.50 per share. Additionally, in the slim chance that a higher bidder would emerge, Reliance would be obligated to pay Leucadia a $12.5-million break-up fee, plus certain expenses. The press release did not carry a statement from Ian Cumming or Joseph Steinberg, chairman and president, respectively, of Leucadia.

But Reliance's Saul Steinberg (who is not related to Leucadia's Steinberg) said that the sale "represents the very best strategic alternative" for Reliance's "*shareholders, employees, and customers*." [Emphasis added.] Since when did Saul Steinberg become so concerned about his employees and customers? Or about shareholders whose last names weren't Steinberg?

Reliance Group and its main subsidiary, the Reliance Insurance Company, are trapped. Reliance Group's debt is coming due and the company has no ready source of liquidity. The rating agencies are breathing down Reliance Insurance Company, and a downgrade by Best below the hallowed "A- (Excellent)" level would probably seal Reliance's fate by sending it into a death spiral. (Standard & Poor's rates Reliance "A-", which means "strong financial characteristics." Moody's rates Reliance Insurance Company "Baa2", which means "adequate financial security.")

None of the rating agencies wants to knock Reliance Insurance Company down to "vulnerable." Two concerns: they don't want to precipitate a collapse, and they don't want to look foolish if the company *doesn't* fail. (Regarding the second concern, even if an insurance company has *only* a one-in-fifty chance of failing, it doesn't deserve a "secure" rating.)

Although all three agencies have Reliance Insurance Company on some sort of "credit watch," the current letter ratings should be disregarded; they do not accurately reflect the company's precarious condition.

The Pennsylvania Insurance Department—assuming that it pays attention to solvency—must be worried about the possibility that Reliance may not make it. The Department, of course, doesn't much care about the fate of Reliance Group Holdings; its concern is about the insurance company. For some time now, Saul Steinberg may have been asking himself the following: at what point will the regulators *prevent* Reliance Insurance Company, which may be severely undercapitalized, from paying dividends up to Reliance Group? Without dividends, Reliance Group Holdings can't service the interest on its debt.

So Steinberg is trapped. Reliance's profitable surety business has been sold to Travelers. What's left is the most volatile stuff—primarily workers' comp and liability. (It could be okay; it could be horrendous. Certainly it is no gem.) Many have looked at Reliance and many have passed. Perhaps it was the price (there was no way to get the company for less than zero); perhaps it was uncertainties about the book of business and the reserves; or perhaps it was simply the "who needs it?" factor. (Do AIG or Chubb *need* Reliance? Wouldn't they, in fact, be better off if the company were put out of its misery?)

Last September we noted that the price of Reliance Group's bonds was at odds with the price of its stock. The bonds were trading, in our words, at "prices [that] imply default," whereas the stock was selling for 4½—a valuation of $516 million. It stood to reason that if the bonds (which are senior to the stock) were not worth par, then the stock was not worth much of anything.

On Friday, Leucadia's stock closed at 26⅝; Reliance closed at 2. Based upon the Leucadia-Reliance exchange ratio of 0.11059346 shares of Leucadia for each share of Reliance, Reliance's stock should be trading around $2.90—*if* the deal was going to happen on the terms that have been reported. Reliance's bonds of '00 and '03 closed at 90 and 78, respectively—prices that also make one wonder about the likelihood of the deal taking place.

According to the Leucadia-Reliance press release, "Consummation [of the deal] is subject to a number of terms and conditions, including various required regulatory approvals, the approval of Reliance's stockholders, and satisfactory completion of Leucadia's due diligence review of Reliance's business and operations."

Our take is that there's little chance that the deal will happen as advertised. (A big variable: Reliance's 11,000,000 shares of Symbol Technologies, worth $550 million as of Friday's close.) Leucadia's Ian Cumming and Joseph Steinberg are tough guys who pay bottom dollar for merchandise that's so ugly and distressed that others won't go near it. They know what they're doing: they don't stretch for deals and have a history of taking calculated, manageable risks. They're smart, shrewd, and have been very successful.

We suspect that when Leucadia completes its due diligence it will either walk away or renegotiate. It's hard to imagine that it will issue $300 million of stock to Reliance shareholders and then pump several hundred million dollars more into Reliance in order to keep the company afloat. (Even if it did that, Reliance would *still* be too leveraged.)

We do not expect Leucadia to provide any unilateral guarantee of Reliance's reserves.

Leucadia, we think, will offer far less for Reliance's common stock. Our guess is that the exchange ratio will be reduced significantly. Perhaps Leucadia will substitute some nebulous piece of paper—a contingent value right based on loss-reserve development, for example. If Leucadia offers too little, however, there's no incentive for Reliance to accept the deal.

As for Reliance's outstanding bonds, those don't appear attractive. The senior debt has 10 points of upside and 90 points of downside. How much leverage do the bondholders *really* have, after all? In a bankruptcy they'd probably have a long, uncertain wait before they *might* see any money.

An offer of Leucadia's stock—at 70¢ on the dollar—might seem like a niggardly deal for the bondholders.

On the other hand, it may be the only game in town.

Lost in the Past

IN LAST THURSDAY'S EDITION we noted that Chemical Bank New York Trust Company was "now known as Chemical Bank." That statement was correct—but only if your calendar still reads March 31, 1996. On April 1, 1996, Chemical acquired, via merger, Chase Manhattan. The combined entity then adopted the more illustrious Chase moniker.

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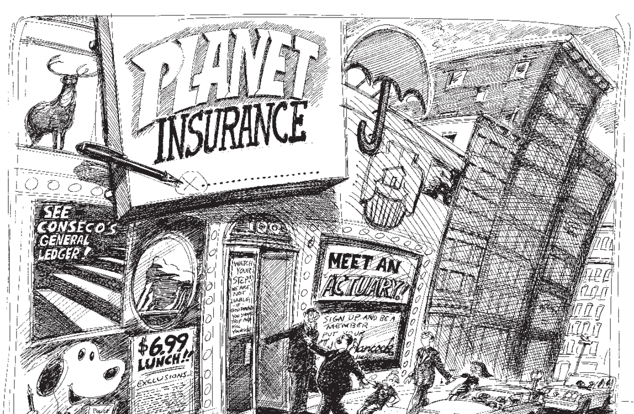

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