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The Long, Unconventional Cycle

PXRE Zigs When it Should Zag

PXRE GROUP LTD. (NYSE: PXT $18.50), previously known as Phoenix Re Corporation, was formed by Phoenix Home Life Mutual in 1986 to carry on the business of its unit Phoenix General, which had been started four years earlier. Although PXRE was once primarily a catastrophe-reinsurance specialist, these days it's allegedly a specialist at many things. Less than half its business is in catastrophe reinsurance. The balance is casualty, structured/finite business, and "other lines" including marine and aerospace.

If there's a lesson to be learned from studying PXRE, perhaps it's this: it's not easy to make money in the insurance business, even if you're in a niche, and even if the public furnishes you with money on advantageous terms.

The Beginning

PXRE went public on March 25, 1987, selling 2.5 million shares at $13 a piece—a price well in excess of book value. Investors were of the mistaken belief that PXRE could earn high returns on its own capital and on reinvested capital. (Few insurance companies have earned a 15% return on capital over a long period of time.)

PXRE did well in 1988 and 1989, but its combined ratio was 120.9%, 117%, 110.6%, and 126.3% over the next four years. During that period its cumulative net loss was $2.5 million.

Hurricane Andrew, which struck in 1992, was good news for PXRE. Underwriters' realization that big catastrophes *really do happen* caused a hardening of the market. Catastrophe-reinsurance prices almost doubled between 1992 and 1994, and PXRE's premiums increased 60% in 1993. (As we've often observed, "bad news is good news" in the insurance business.)

The shortage of a commodity—catastrophe reinsurance—created a favorable pricing environment which helped PXRE tap the public equity markets again and again and again. In 1992 it issued $25 million of convertible preferred shares. In 1993 it netted $47 million from an offering of 2.3 million shares. (The shares were priced at almost twice book value—a lofty price, and one that assumed, as before, that the company would be able to earn high returns on its capital over a prolonged period.) Then, in late 1993, PXRE's subsidiary, Transnational Reinsurance, completed a $100-million offering, after which PXRE owned 21% of Transnational. (PXRE also provided services to Transnational, for which it received a management fee.) In 1996, PXRE "purchased" Transnational for stock.

The years 1993 through 1997 were profitable for PXRE, 1994 being the peak. Return on equity averaged 18%, and book value—benefiting from the equity infusions as well as earnings—grew from $11.20 per share at the end of 1992 to $28.10 by the end of 1997. (PXRE's stock briefly got above $30 in late 1993 and did so again in early 1998.)

Business conditions don't usually remain favorable for prolonged periods in the insurance business, and PXRE's business was no exception. In early 1998 the company postulated that "future market cycles may not follow conventional patterns"—that any upturn after a large catastrophe would be mitigated by large pools of offshore capital eager to get into the business. PXRE's theory presumed that there is a "conventional" cycle—a presumption we don't share. Although we're believers in the cyclicity of the insurance business, we believe that the cycles occur in a surprising, unconventional, and unpredictable fashion. Indeed, if cycles were conventional, they would be predictable, and companies would only write business during an up cycle and never write business during a down cycle. Such behavior would result in a complete balance of supply and demand—which would, of course, eliminate cycles entirely.

Believing that a "new paradigm in the property catastrophe market" was at hand, PXRE decided to diversify its operations. (As insurance history has shown, diversification does not necessarily provide protection against the vicissitudes of the insurance markets. Diversification is often executed poorly, and, to the best of our knowledge, there are no insurance markets that are always profitable.) PXRE formed a Lloyd's syndicate, and began writing non-standard and excess property risks. "We

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also began to look at the correlation of business and financial risks," wrote chairman, president, and CEO Gerald Radke in the 1998 annual report. "And, with this broader view, we implemented an investment strategy intended to make our capital work harder and thereby counterbalance the higher levels of catastrophe activity that might occur from time to time."

Although the company's capital may be working harder, the company's balance sheet doesn't look as if the workout agrees with it. By the end of 2000, PXRE's shareholders' equity stood at $260 million. Against this is $165 million of debt and preferred stock outstanding. Additionally, $110 million (22%) of the investment portfolio is invested in hedge funds, and $47 million is in investment partnerships.

The juiced-up balance sheet hasn't brought success. PXRE earned $2.7 million (26¢ per share) in 1998. It lost $49 million ($3.64 per share) in 1999, and $10.8 million (95¢ per share) last year. Book value declined to $21.94 per share at December 31, 2000.

Anticipating a Turn in the Cycle

We've mentioned PXRE in the past. In our December 1999 issue we noted that insurance stocks were severely out of favor. "Some stocks are so cheap relative to book value that it seems as if the situation cannot endure for many years," we wrote. "At its recent price of 10¼, PXRE…is selling for 40% of book value. (For the record, we're a shareholder.) At this price, we can envision several scenarios: 1) the stock rises because it is so cheap; 2) someone—perhaps a financial buyer rather than a strategic buyer—attempts to take over the company; 3) PXRE pisses its capital away to such an extent that its stock is no longer cheap."

In the fourteen months since those words were written, two of the three scenarios have come to pass, sort of: 1) PXRE has lost money and its capital has declined; 2) PXRE's stock has risen sharply. Earlier this week it was $20, although it's now $18.50.

PXRE's stock has risen, we believe, because it was ludicrously undervalued and because investors now have a more optimistic view of the reinsurance industry's prospects during the next couple of years.

It's likely that PXRE will do better this year than last, but it's hard to say with any certainty whether 2005 will be better or worse than, for example, 1998. The company's diversifications may have served to expose it to more volatile markets in which in has less expertise. As a monoline catastrophe reinsurer with a handful of employees, it's easier (financially, not emotionally) to sit on the sidelines and do nothing during periods of inadequate pricing. As insurance companies grow and become diversified, however, sitting out tough times seems to be difficult to do.

Investors have bid up PXRE's stock in anticipation of better times ahead. Although the stock is still way below its 1993 high, it is no longer severely undervalued. Indeed, as of Monday, it seemed reasonably valued. On Tuesday we sent an e-mail to a friend who, like us, has a keen interest in insurance stocks: "Sold three-quarters of our PXRE yesterday," we wrote. "It's still a bit below book value—not a level that we usually sell a stock—but given the bad management, lousy track record, leveraged balance sheet, and the possibility for unpleasant surprises, we figured that we had four or five points of upside and much more of down. Of course it's always possible that the stock could go wild and trade at a huge premium of book, but it just isn't worth it. We much prefer IPC Re [an underleveraged monoline catastrophe reinsurer] to PXRE, although we're looking to sell that, too, when we have a longterm gain [rather than our current short-term gain]."

We are not the only ones looking to sell. Markel, Hartford, and W.R. Berkley have recently announced secondary offerings of stock, and we expect many others to announce deals, too, either out of necessity (Mutual Risk Management) or a desire to take advantage of favorable stock market conditions.

We don't expect AIG, which sells for 35 times earnings and 548% of book value, to issue stock in a secondary offering. AIG is so large ($200-billion market cap) that it couldn't do an offering large enough to be meaningful. Hank Greenberg has said, however, that AIG is looking at acquisitions, and given his company's stupendous p/e multiple, we'd be surprised if his currency of choice was not AIG stock.

A hard market is the result of fear and a shortage of capital. If insurance companies can get all the capital they need from the capital markets—as opposed to getting it from earnings—then there's no reason for a hard market.

The insurance business has always been cyclical, and the cycles have always been unconventional. In that respect, we don't expect this cycle to be any different from the last.