Weitz | INVESTMENT MANAGEMENT

Markel Corporation (MKL)

A History of Growth, A Future Full of Potential

Markel Corporation (MKL) is a diversified holding company with primary operations in specialty insurance – a type of insurance that provides coverage for hard-to-place risks not typically covered by traditional retail insurance companies. As the name implies, specialty insurance requires highly specialized expertise to fit coverage to customers' unique needs. This market is significantly different than the standard insurance market where rates and forms are highly regulated, products have little variation, and companies compete mainly on price. Specialty insurance providers tend to focus less on price and compete on product availability, service, and expertise.

Product lines in MKL's insurance segment (roughly 80% of premiums) include liability coverage for highly specialized professionals, workers' compensation insurance for small businesses, and individuals. The company also taps into niche areas like custom cars, museums, summer camps, childcare centers, and marine-related activities – just to name a few. In addition, MKL has a smaller reinsurance segment that underwrites property and casualty treaty coverage to other insurance and reinsurance companies globally.

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A history of growth

Through 90 years of accumulated expertise in generally less commoditized product lines, and with disciplined underwriting criteria supported by aligned incentives, MKL has steadily grown annual premiums while generating consistent profits.

Like Berkshire Hathaway, growth in premiums has translated to steadily increasing ***insurance float***. Since Markel, on average, tends to generate profits from underwriting operations, they are in the enviable position of having a negative cost of float – in other words, they are being paid to hold onto capital. This indicates operations are being run very efficiently.

Insurance float is the available reserve that an insurer has collected in premiums but not yet paid out in claims. Insurers invest premiums as soon as they are collected creating a source of earnings and income.

Underwriting profits are just one source of ongoing return for MKL. The company uses its float, retained earnings, and a modest amount of debt to invest in fixed income and equity securities. The fixed income investments are designed to more than match policy claim liabilities, while the equity portfolio complements investments in the core business to augment shareholder rate of return. Over the last 15 years, management has also acquired many small non-insurance operating businesses, collectively known as Markel Ventures. These businesses span a diverse set of industries ranging from bakery equipment manufacturing to management consulting services. Additionally, MKL has acquired a small number of market-leading, fee-based companies that complement MKL's traditional reinsurance offering (discussed in further detail below). Together, MKL has a long list of capital allocation options, with each providing diversified sources of ongoing cash flow.

Of course, MKL's growing cash flow, coupled with a wide menu of reinvestment opportunities, is only as good as the managers making the capital allocation decisions. In this regard, MKL's management has a commendable track record. For instance, under the direction of the same management, MKL's public equities portfolio has consistently bested the S&P 500 over the last 5, 10 and 20-year periods with limited turnover in what we believe are high-quality holdings. On the private business side, our math shows that Markel Ventures has produced returns exceeding MKL's cost of capital largely through opportunistic purchases at low to reasonable transaction multiples. As a marker of consolidated success, book value per share has compounded at a 16% annual rate since the company's IPO in 1986, increasing from $6 per share to $803 per share through the fourth quarter of 2019.

The opportunity

While the team at Weitz has followed MKL for some time, we began building a position in the Partners III Opportunity Fund in 2018. Then, in late 2019 as the share price began to lag our internal estimate of intrinsic value, we initiated positions in Hickory, Partners Value, and the Balanced funds.

MKL's share price underperformed in 2018 and 2019 with arguably no single catalyst, however, the most obvious noise centered around the company's entry into new business lines that principally match third-party reinsurers and alternative capital providers (e.g. hedge funds, pensions, wealthy individuals, etc.) with other third-party insurers and reinsurers looking to offload risk. A string of acquisitions starting in 2015 added CATCo and Nephila Capital – two market-leading ***insurance-linked securities (ILS)*** fund managers. MKL also acquired the leading ***fronting company*** (State National). While these acquisitions added to an already complex array of businesses, they have positioned MKL as a well-informed, high margin toll taker on growing alternative capital participation in both the insurance and reinsurance markets.

Insurance-linked securities (ILS) are financial instruments, sold to investors, whose value is affected by an insured loss event. ILS encompasses catastrophe bonds and other forms of risk-linked securitization.

Fronting is a business model in which a licensed insurance company underwrites policies and then cedes the entirety of the risk to a third-party reinsurer (which could include ILS vehicles).

This is not to say that MKL hasn't experienced growing pains. Perhaps the loudest noise and related overhang to MKL's share price came from the ultimate failure of CATCo. CATCo focused on ILS that reinsure the catastrophe tail risk of other reinsurers. In other words, high risk with high potential returns. This formula worked until it didn't when 2017 and 2018 brought the worst two-year catastrophe period in history. Add to the mix a management team that significantly underestimated losses, and you had a reputational issue that effectively forced MKL's hand to put CATCo into run-off, meaning CATCo will honor remaining claims and release all remaining assets under management over the next two to three years.

It is very important to note that CATCo was, by far, the smallest of MKL's three alternative capital businesses, had a higher risk profile, and the ultimate losses are relatively well known. On the other hand, Nephila and State National continue to perform well, have long track records, and are run by highly regarded and long-tenured management teams. Further, as clear market leaders, we believe each will likely continue to benefit as alternative capital providers – always on the hunt for yield and diversification –allocate more capital to reinsurance as the ILS market matures. The combination of attractive growth prospects and outstanding free cash flow margins suggests these businesses have the potential to become an increasingly important driver of returns at MKL.

Getting back to intrinsic value, our base case model (prior to fourth quarter 2019 earnings) suggested that we were able to purchase MKL for something equivalent to the value of the insurance business (burdened by consolidated debt) and Markel Ventures ($2+ billion of run rate revenue and a mid-to-high single digit free cash flow margin) at a meaningful discount, and effectively pick up the alternative capital businesses for free. In total, the discount to intrinsic value looks attractive, and our research gives us confidence that MKL can continue to grow its intrinsic value at a low double-digit rate of return for many years to come.