Property Casualty Intelligence Briefing

Inside P&C

by The Insurance Insider

August 7, 2019

HEDGE FUND RE: THE IRONY FACTORIES

With pressure coming from all sides, the first generation of total return vehicles appear to be getting less room to maneuver.

It's tough out there for total return reinsurers. Already under pressure from sub-par financial performance and weak valuations, over the past few months, the group has seen pressure dialed-up from updated PFIC tax guidelines, and an apparently less accommodative stance from AM Best.

In response this week, **Greenlight Re** announced a strategic review, in what appears an attempt to head of criticisms around shareholder value creation. (Indeed, they beat us to the punch by a day ☺)

However, the announcement brings into sharp focus the concerning track record of the group. The firms were originally marketed as an attractive entry point to gain access to "super star" hedge fund managers, with attractive tax features, and an opportunity to turbo-charge investment returns with underwriting gains.

Even so, following years of underperformance on both underwriting and investments, the two public "first generation" vehicles **Third Point Re** and **Greenlight Re** began this week with valuations ~30% below book value.

It is perhaps ironic enough that these "total return" firms have failed to deliver investment returns at levels even lower-risk corporate bonds have achieved or even in line with risk-free rates (see details below).

At any non-conflicted company, it is highly likely an underperforming investment manager would have been cut back or cut loose years ago. Though fees were modestly lowered at both last year, the fact remains that since its IPO, **Greenlight Re** has paid $356mn in investment fees over 12 years while **Third Point Re** has paid $409mn over six. A zero cost strategic review from *Inside P&C* instead of Credit Suisse would put the money in index funds and pay the fees to shareholders instead.

The old joke about hedge funds is that they exist not to beat their benchmarks, but to extract fees for hedge fund managers. In that sense, what makes a "successful" hedge fund is not a track record of out performing a relevant benchmark, but the ability to raise funds to earn fees from. In that regard – and perhaps that regard alone – the first generation of total return reinsurers have been a total success.

And here's the added twist of irony. This use of corporate assets arguably in the service of a founding minority shareholder in a way that could be seen as happening at the expense of the majority of shareholders is the kind of conflict of interest that one could imagine both Third Point and Greenlight targeting in their sometimes assumed role as corporate governance purists via shareholder activism or as short sellers. Ditto the use of a "cult of personality" to maintain access to capital markets.

Our view is that the current valuations of total return reinsurers are unsustainable, and that the group are vulnerable to M&A and activism.

Finally, it is worth noting not all total return vehicles are created equal, and the next generation of firms including **ABR Re**, **Watford Re**, and **Hamilton** all have distinguishing features. Even so, all are likely to face spillover scrutiny, which we will explore in Part 2 of this series.

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Index	QTD	YTD
Large Cap	**1.4%**	**22.9%**
Regional	**(0.2)%**	**11.5%**
Specialty	**2.3%**	**22.0%**
Personal	**(2.4)%**	**19.4%**
Bermuda	**3.3%**	**29.4%**
Florida	**(9.8)%**	**(25.1)%**
IPC Select	**(0.4)%**	**9.2%**
S&P 500	**(2.0)%**	**15.0%**
S&P Fin.	**(2.1)%**	**13.5%**

Source: S&P Global, Inside P&C

HEDGE FUND RE: THE IRONY FACTORIES

❖ ***Greenlight Re's strategic review is likely a taste of things to come as hedge fund re sees increased scrutiny of the model from key gate keepers, limited operating flexibility, and valuations that invite M&A or activism***

It's tough out there for total return reinsurers. Already under pressure from sub-par financial performance and weak valuations, over the past few months, the group has seen pressure dialed-up from updated PFIC tax guidelines, and an apparently less accommodative stance from AM Best.

Following years of underperformance on both underwriting and investments, the two public "first generation" vehicles Third Point Re and Greenlight Re began this week all with valuations below 0.62x book value – well below P&C averages.

EXHIBIT: CUMULATIVE % CHANGE IN PRICE-TO-BOOK

Source: S&P Global, Inside P&C

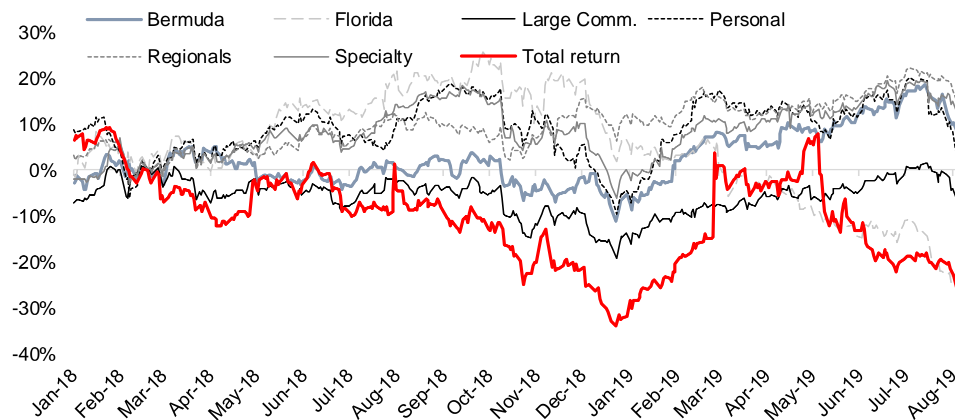
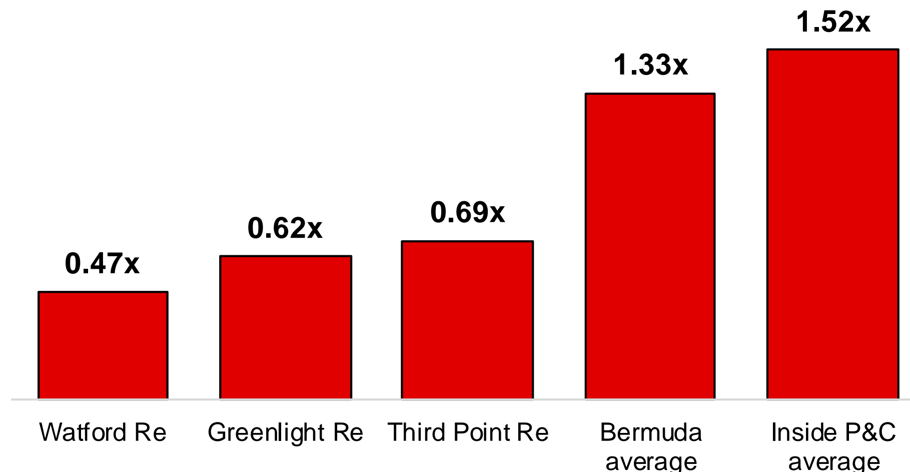


EXHIBIT: PRICE-TO-BOOK MULTIPLES AT AUGUST 2, 2019

Source: Company reports, Inside P&C



These pre-existing pressures have been dialed up in recent weeks by two factors: the introduction of revised guidelines for Passive Foreign Investment Companies (PFICs), and an apparent shift in stance from AM Best.

PFIC guidelines update

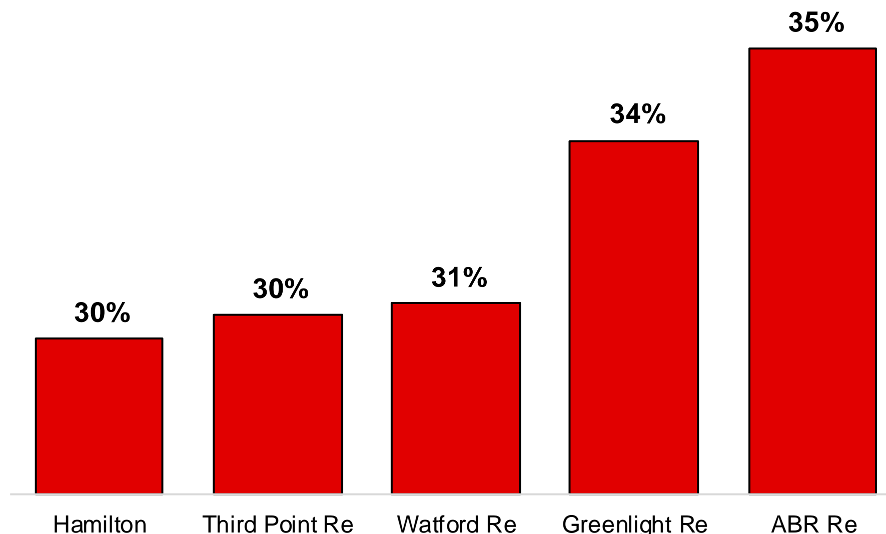
Last month, the Internal Revenue Service (IRS) and Department of Treasury issued proposed updates to the regulations on PFICs, including the exemptions to qualifying insurance companies that are crucial to total return (re)insurance strategies and their tax treatment. The update included four crucial points.

- First, the IRS confirmed its prior guidance on a bright line test for qualifying insurance companies to require insurance liabilities to be at least 25% of assets. This is in line with prior proposals and therefore does not come as a surprise. Indeed, all public firms currently clear this hurdle = unsurprisingly given it has been given as a yard stick to manage to.
- Second, law firm Eversheds noted a change of language around what exactly counts as an insurance liability, which could add some complexity. Even so, these are likely to be ironed out during the consultation period.
- Third, it is also worth noting that some recent transactions by some companies to shift financial investments into a levered affiliate investment could come under scrutiny under the new proposals (= requires only reporting the net asset vale on the balance sheet, not total assets).
- Fourth, the proposals include additional detail around a potential bright line test for insurance activities around the use of underwriting managers. Note this could cause problems for outsourced underwriting vehicles, though the complexity may lead to revision during the consultation period.

Finally it is worth noting the regulations would only come into effect the year after they were finalized, providing plenty of run-way for both further changes and a period to adapt.

EXHIBIT: 2018 LOSS AND LAE RESERVES AS A % OF ASSETS

Source: Company reports, Inside P&C



Rating Agencies: AM Best signals a tougher stance

Another factor contributing to the increased pressure on total return reinsurers is the apparent shift in stance from rating agency AM Best. Recall, AM Best is the key agency for hedge fund reinsurers after S&P took a strong stance against the business model in 2016.

Industry sources have privately challenged the view that Best is taking a wholesale change in approach to the total return business model rather than responding to particular challenges at companies as they manifest, in this instance the hedge fund re firms.

However, whatever the trigger, the agency does appear to be signalling a less accommodative stance in its public comments and rating actions.

Note, the firm has put both Third Point Re and Greenlight Re on negative watch and its language around pushing for an improvement in underwriting results across the broader group does appear to carry an implicit (or occasionally explicit) "or else" attached to it.

Additionally, Greenlight Re explicitly acknowledged on its second quarter call the negative outlook and the pressure from Best was a major trigger for its strategic review.

> *"As we announced on May 31, as a result of AM Best's decision to revise the outlook of our financial strength rating of A- from stable to negative, we have partially derisked our investment portfolio and commenced a strategic review led by the Board of Directors." - **CEO Simon Burton***

EXHIBIT: AM BEST RATINGS

Source: AM Best Company, Inside P&C

	AM Best rating	Outlook	Most recent action	Commentary
Hamilton	A- (excellent)	Stable	Rating reaffirmed (May 31, 2019)	AM Best expects Hamilton to achieve an underwriting break-even point within two years, the absence of which, regardless of investment results, could result in negative rating pressure
Watford Re	A- (excellent)	Stable	Rating reaffirmed (May 17, 2019)	Going forward, AM Best expects the company's underwriting performance to improve and be more in line with the industry average.
Third Point Re	A- (excellent)	Negative	Revised outlook to negative from stable (May 16, 2019)	The negative outlooks reflect AM Best's concern over the company's business profile given its prolonged inability to generate an underwriting profit.
Greenlight Re	A- (excellent)	Negative	Revised outlook to negative from stable (May 31, 2019)	AM Best expects GLRE to improve its underwriting profitability. Failure to do so may result in further negative rating actions

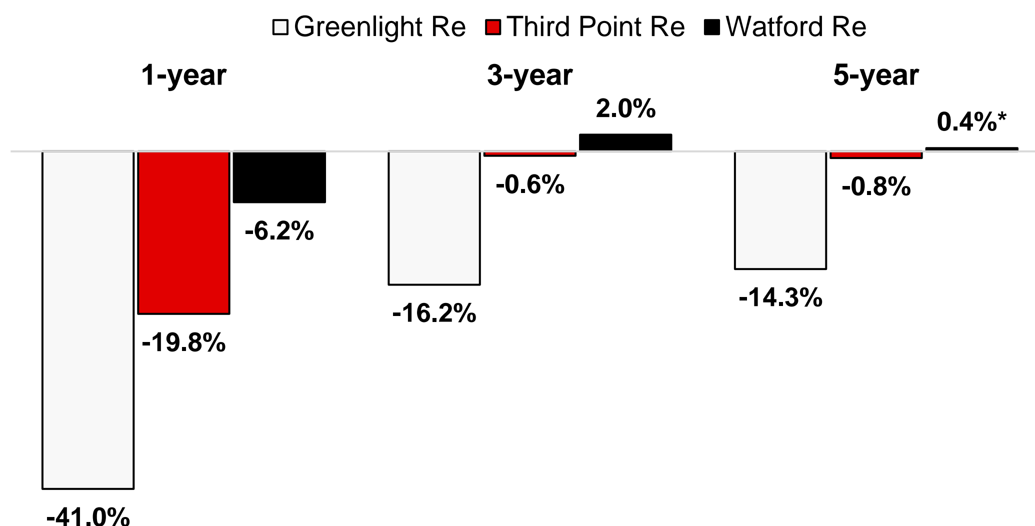
Financial performance

Of course, a huge part of the pressure on these companies is arguably not due to the model *per se*, but simply due to poor results. Certainly other total return companies have been keen to point out the differentiating factors that separate them from a Greenlight or a Third Point.

Note, both Greenlight and Third Point Re have negative total value creation across a 1 year, 3-year, and 5-year time horizon.

EXHIBIT: ANNUALIZED TOTAL VALUE CREATED ON TANGIBLE BOOK VALUE PLUS DIVIDEND BASIS

Source: Company reports, Inside P&C



Our view has been that the hedge fund reinsurance model fundamentally suffers not from access to quality underwriting talent, but from quality distribution and access to business. Recall, the use of highly regarded underwriting talent was a key part to the Third Point Re pitch to investors, including former Chubb executive John Berger.

The problem has been that a combination of elevated financial risk, a limited track record, and weaker financial strength ratings relative to some competitors has driven an adverse selection problem for access to business.

Note that theoretically, a superior investment performance could be used to win less credit-sensitive clients by an explicit profit-sharing mechanism or else implicitly through lower pricing. However, the weak investment performance of both Greenlight and Third Point has instead exacerbated this adverse selection problem, by both eliminating any perceived synergies to split and calling into question the sustainability of the firms and their counter-party credit worthiness (e.g. the negative watch from AM Best on an A- rating).

Operating performance

Note the firms' weak financial results have been driven by both sides of the balance sheet. Investment income generated by these "total return" companies have ironically underperformed even risk-free assets over long time horizons, while their underwriting results have generated float largely at disappointing costs.

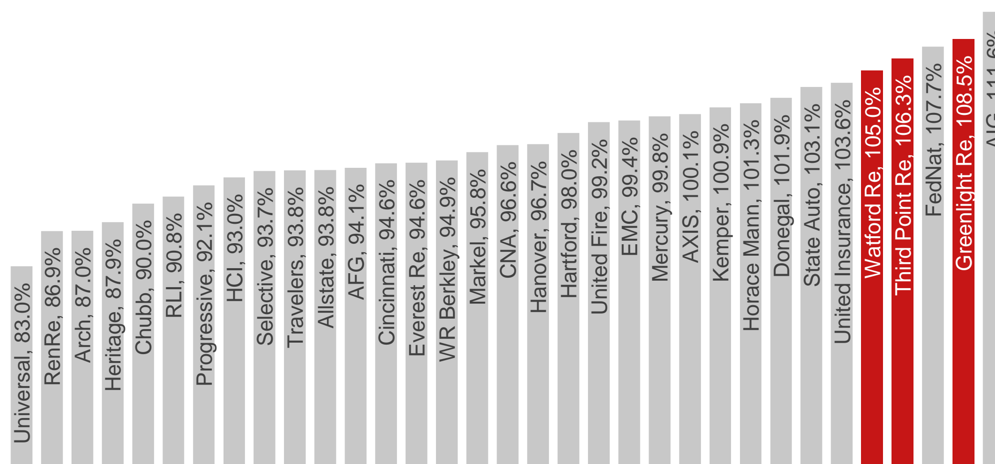
EXHIBIT: INVESTMENT INCOME

Source: Company reports, S&P Global, Inside P&C

	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	5Y CAGR	10Y CAGR
Greenlight Re	13.5%	4.9%	1.1%	3.2%	7.7%	4.4%	-11.6%	3.3%	0.7%	-32.7%	-8.4%	-1.4%
Third Point Re	NA	NA	NA	13.0%	15.3%	3.8%	-1.1%	3.3%	11.1%	-11.2%	0.9%	NA
Watford Re	NA	NA	NA	NA	NA	1.5%	4.1%	4.5%	3.4%	3.8%	3.5%	NA
Inside P&C average	4.2%	4.1%	3.2%	3.5%	3.1%	3.0%	2.7%	2.9%	3.1%	2.6%	2.9%	3.2%
US Treasury 10-year avg yield	2.5%	2.4%	2.4%	2.2%	2.6%	2.4%	1.8%	2.6%	3.6%	3.1%	2.7%	2.6%
S&P 500 inv.grade corp avg yield	3.7%	3.2%	3.4%	3.2%	3.0%	2.8%	2.9%	3.4%	3.8%	4.4%	3.5%	3.4%
S&P 500 Index	-6.2%	19.4%	9.5%	-0.7%	11.4%	29.6%	13.4%	0.0%	12.8%	23.5%	15.4%	10.7%

AVERAGE COMBINED RATIOS (PERIOD: 2015-2018 FISCAL YEARS AND Q1:19)

Source: S&P Global, Inside P&C



Greenlight Re announces strategic review

On Monday this week, Greenlight Re announced it had appointed Credit Suisse to conduct a strategic review. On its investor call on Tuesday, chairman David Einhorn spelled out potential sources of value the company would look to monetize as it conducts its strategic review in order to close the valuation gap between book and market values in hopefully "a relatively short order".

> *"The strategic review led by Credit Suisse is designed to find the best strategic direction for the company. The company has, we believe, a number of attractive assets, including its underwriting team and existing book of business in Cayman and in Ireland. We think that the investment program itself has value. We think that the public listing has value.* We think that the team that is in place has value*. And we are looking with Credit Suisse in a way to improve the company's business position and structure and deal with whatever pressure is coming from the rating agencies"* - **Chairman David Einhorn**

Our view is that this strategic review was timely giving the building pressure of an unsustainable discount to book value that could have attracted attention from either unsolicited M&A approaches and/or shareholder activism.

In particular, we view a combination of renewal rights and legacy transactions a potential avenue to unlock shareholder value for similarly situated companies, as we explore below. Similarly, another obvious opportunity would be for a reverse merger for a company looking to both build scale and by-pass an IPO.

However, the pre-emptive strike of a strategic review buys the company time to control both the messaging and the process, and increases the likelihood the principals are able to engineer an outcome beneficial to themselves, including the continuation of fees to the hedge fund in some capacity (though notably they have largely been suspended due to the de-risking of the portfolio through year-end).

Third Point Re pressures seem evident too

We think it is also worth noting that there are signs of corporate strain at Third Point Re. Though there has been no formal announcement around a new strategic direction, it appears significant that the company recently announced the departure of CEO Robert Bredahl in May and board member Neil McConachie in July.

Market sources have suggested that the reinsurer's relationship with its sponsor hedge fund has been a source of tension among some members of both management and the board.

Hedge Fund fees

It is perhaps ironic enough that these "total return" firms have failed to deliver investment returns at levels even lower-risk corporate bonds have achieved or even in line with risk-free rates.

At any non-conflicted company, it is highly likely an underperforming investment manager would have been cut loose or cut back for underperformance years ago.

Though fees were modestly lowered at both last year, the fact remains that since its IPO, **Greenlight Re** has paid $356mn in fees to DME Advisors over 12 years while **Third Point Re** has paid $409mn over six.

The old joke about hedge funds is that they exist not to beat their benchmarks, but to extract fees for hedge fund managers. In that sense, what makes a "successful" hedge fund is not a track record of out performing a relevant benchmark, but the ability to raise funds to earn fees from. In that regard – and perhaps that regard alone – the first generation of total return reinsurers have been a total success.

EXHIBIT: INVESTMENT MANAGEMENT FEES PAID

Source: Company reports, Inside P&C

in thousands $	2016	2017	2018
Third Point Re	59,707	130,751	37,221
As a % of net investment income	38%	25%	(neg. NII)
As a % of invested assets and cash	2.0%	3.7%	1.7%
As a % of total assets	1.5%	2.8%	1.2%
Greenlight Re	24,543	19,863	14,321
As a % of net investment income	24%	50%	(neg. NII)
As a % of invested assets and cash	1.0%	0.7%	1.5%
As a % of total assets	0.9%	0.6%	1.0%

Note that last year, all three of Watford Re, Third Point Re, and Greenlight Re negotiated smaller management fees with their investment advisors.

Additionally, Greenlight indicated this quarter that the portion of its de-risked assets held in cash and investments will not be subject to management fees for the next six months during the strategic review.

However, we would question whether the continuation of the relationships are in the best long term interest of a majority of shareholders versus other strategic alternatives. A reduced fee following significant underperformance appears to us at least a day late and a dollar short.

An opportunity for an activist?

With the valuations at such low levels there is a potential for the emergence of an activist on the firms' shareholder registers. This seems particularly true given the increased shareholder activism in the industry.

Some recent examples in the table below.

EXHIBIT: EXAMPLES OF INVESTOR ACTIVISM AT P&C INSURANCE FIRMS

Source: Inside P&C, The Insurance Insider

Activist	Target	Intentions/Actions
Carl Icahn and John Paulson	AIG	Capital return, expenses, underwriting, CEO-change
Carl Icahn	AmTrust	Pushing for higher bid on a takover deal
Voce Capital	Argo Group	Capital return, expenses, underwriting, board seats
CIAM	Scor	Push for sale, Chairman removal, executive pay cut
TimesSquare Capital	RenaissanceRe	Push for sale, strategy change
683 Capital Management	Maiden	Capitalization, ownership structure, board, operations
Capital Returns	FedNat	Board seat, de-classify board, hold meeting

The low valuation presents a potential entry point for an activist due to the wide margin of safety provided by the trading discount to book value, which could be unlocked by a change in corporate strategy.

Possible strategic actions to accelerate returns could include full or partial asset sales – both flagged as potential by Greenlight. Note that legacy transactions without a sale of the company are unlikely due to the potential to cause tax complications.

Note one potential avenue is a "carve-up" transaction, with a combination of a legacy and live player. This typically sees a live bidder purchase the portfolio renewal rights, with the legacy acquirer bidding for the run-off. These transactions often unlock more value from the sum-of-the-parts than a single buyer is willing to bid for either.

Past examples include the carve up of American Safety between Catalina and Fairfax financial in 2013 following the activist campaign of Catalina, the sale of Maiden's North American reinsurance entity to Enstar (run-off) and the renewal rights in a cut-price deal to Trans Re in 2018, and the sale of Brit's UK book back in 2012 to QBE (renewal rights) and Fairfax unit RiverStone (run-off).

Takeover and activist defenses

However, despite the theoretical corporate tools to prevent a business from potentially continued value-destruction, they are not always easily accessible.

Companies' corporate governance provisions are oftentimes designed in a way to limit possible actions resulting from aggressive third-party involvement, even if it benefits its shareholders.

Both Greenlight Re and Third Point Re have such provisions in place – an irony given both Greenlight and Third Point have often played the role of corporate governance purists in their occasional acts of shareholder activism or criticisms of companies they have sold short.

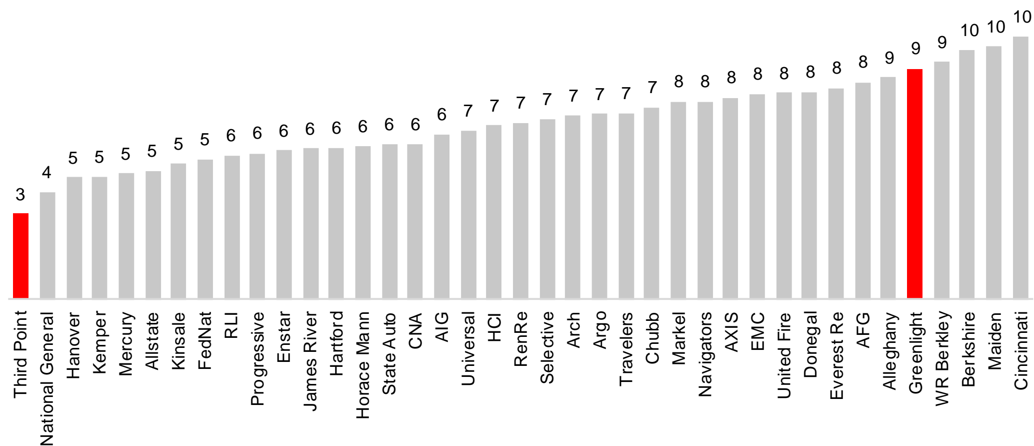
To start with, Greenlight's founding documents allow the company to require a shareholder to sell his shares if the firm's board determines that the ownership may result in adverse consequences to either the company, its subsidiaries or any of its shareholders – a fairly typical protection due to tax issues.

However, there are some less typical boardroom protection clauses too. The company allows replacing a director for no "cause" only with the support of no less than 80 percent of shareholders, the "cause" implying very serious misconduct, e.g. drug or alcohol abuse, conviction by a court, fraud, willful failure, material breach of company policies, reputational harm, etc.

This limits the activist's chances of having a dissident in the boardroom, let alone promoting major shifts in the business strategy. This is particularly relevant since Greenlight Re's average board tenure of nine years is among highest in the industry.

EXHIBIT: AVERAGE BOARD TENURE

Source: Company reports, S&P Global, Inside P&C



In Cayman-based Greenlight Re's dual-class share structure the voting power is skewed to favour Class B shares, as every Class B share is entitled 10 times the voting power of a Class A share. All currently outstanding Class B shares are owned by David Einhorn, the chairman and the president of the company managing Greenlight Re's contributions in the hedge fund.

However, the voting power of Class B shares is limited to a total of 9.5 percent, implying that David Einhorn cannot exercise the voting power of all his 17 percent stake in the company. Yet, that also means should David Einhorn sell 90 percent of his current shares he would still exercise the same amount of voting power, as Class B shares automatically convert to Class A when they change hands. *Note the limitation on voting power to 9.5% is likely due to tax implications, not corporate governance best practice.*

Furthermore, an activist intended to change investment structure at Greenlight would have to wait until at least August 2023, when the current agreement with the hedge fund terminates and automatically extends to sequential three year

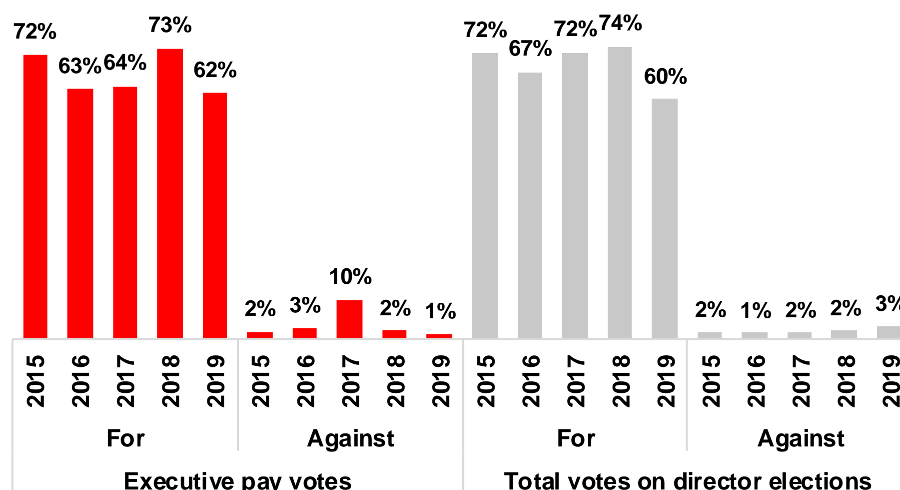
terms given no termination request from either sides, albeit both sides have shown a willingness to be flexible due to existential rating agency pressures.

According to so-called agreement of participation with the hedge fund, Greenlight does not have the power to appoint, change or replace the investment manager or the fund's general partner except "for cause". Also, the company is unable to participate in making investment decisions in relation to the investments allocated to the hedge fund as long as the fund adheres to the pre-agreed investment guidelines.

That, coupled with the track record of little shareholder dissent, makes Greenlight Re not an easy activist target.

EXHIBIT: AVERAGE BOARD TENURE

Source: Company reports, S&P Global, Inside P&C



Similarly, Third Point Re's by-laws include provision to prevent takeover attempts.

- The first provision provides shareholders the right to act by majority written consent for so long as the lead investors and the Loeb Entities collectively hold at least 35% of the firm's issued and outstanding common shares.
- The firm also requires advance notice of shareholders' proposals in connection with annual general meetings, as well as having a classified board of Directors.
- In addition, the ability to issue "blank cheque" preferred shares lowers the firm's attractiveness as a takeover target.
- Business combinations with persons acquiring at least 15% of Third Point Re's common stock for a period of three years from which the date the position was built is also prohibited unless approval is obtained from the company prior to the acquisition.

Other provisions include rules regarding the removal of directors, and supermajority shareholder voting requirements to effect certain amendments to the firm's memorandum of association and bye-laws.

Third Point Re is bound to Third Point LLC, Daniel Loeb's hedge fund managing the Bermudian's investments, by the limited partnership agreement with next termination date in December 2021 and subsequent automatic renewal every three years until 6-month notice prior to a scheduled termination.

Opportunity for M&A

According to reporting by sister publication *The Insurance Insider,* Greenlight Re is likely to draw very limited takeover interest given its weak underwriting franchise and the ratings agency and regulatory pressure.

Industry sources said the firm's preference is likely to be for a merger deal that would add additional premium volumes to the business and allow a continued – but smaller – allocation of assets to chairman David Einhorn's hedge fund Greenlight Capital. However, only businesses looking to solve a problem are likely to be interested in pursuing such a transaction.

According to sources, recently-listed Bermudian reinsurer Sirius is keen to further dilute down the 96 percent stake in the business held by China Minsheng and has made it clear to investment banks that it is open to merger transactions.

A paper deal between the two companies would offer Sirius the chance to achieve this strategic objective, while merging Greenlight into a much bigger underwriting business that would clear regulatory hurdles, but which would leave scope for some allocation of assets to Einhorn's hedge fund going forward.

Another category of potential merger partner would be businesses looking to go public via a reverse merger. One source suggested this could include privately held Caribbean insurers – who may be comfortable with Greenlight's Cayman Islands-domicile – or Lloyd's insurers that have struggled to secure deals.

Sources are skeptical that there will be meaningful private equity interest given the weak underwriting franchise, Cayman Islands domicile, and the unattractiveness of the hedge fund component of the strategy.

There has been talk in the past about a possible tie up with Third Point Re before Rob Bredahl exited as CEO, but it is difficult to see that this transaction would solve the issues faced by either company.

With the company trading at 0.6x book before the strategic review and the retention of Credit Suisse was announced, there is potentially scope for a bidder to be attracted in by the weak valuation.

If such a deal cannot be secured, Credit Suisse may look for a deal with a legacy counterparty, with Enstar and Catalina the likeliest names given their scale and financial resources.

Separately, M&A seems unlikely at Watford despite the significant valuation discount, as the relationship to Arch is a crucial source of value that would likely be lost in the event of M&A or activism.

This research report was written by Insider Publishing's Research team which includes Gavin Davis, Gianluca Casapietra, and Dan Lukpanov.

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