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Why one short-seller sees trouble for Fairfax: An Australian parallel?

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Let's get the disclosure out of the way right off the top: our unnamed source is an overseas hedge fund investor with deep pockets and a strong suspicion life is going to get more difficult for **Fairfax Financial** Holdings Inc. He is also short on the shares and we at the Financial Post are always wary of playing into anyone's hands who has an angle on a company's prospects that might swing the firm's shares -- in either direction.

His take on Fairfax is based on his own experience watching firsthand the demise of HIH Insurance, whose bankruptcy, the largest in Australia's corporate history, led to a major Royal Commission of enquiry. We aren't about to recommend investors follow his conclusions and sell or short the stock, but figured it was worth sharing his concerns. Fairfax did not return phone calls from the Post requesting an interview.

We're certainly not surprised the firm refused comment: The insurance conglomerate's chief executive Prem Watsa has a particularly intense dislike of short sellers and has made it a habit to blame them for his company's often rocky ride in the market over the past few years.

Our short seller has gone to great lengths to draw parallels between Fairfax's current position and that of HIH prior to its downfall. And if he is ready to bet his money on that scenario unfolding, we figured it merits laying out the foundations of his case, whatever their merit. "As you can probably tell," he makes it clear, "I am utterly obsessed with Fairfax." It could prove to be his downfall if his concerns prove unfounded.

As for HIH, hindsight says warning bells were ringing 18 months before its doors shut in March, 2001, and if heeded, could have prevented the crippling of countless industries and saved taxpayers a hit that has already reached A$200-million (a token amount of what the government is expected to shell out to cover unpaid claims).

HIH dug its hole through poorly assessed acquisitions and the use of reinsurance that served only to pad the balance sheet.

Most importantly, HIH paid for the failure to put aside enough cash to cover steep losses from workers compensation and other insurance policies where premiums and claims are separated by years.

Critics of the HIH business model were silenced, or denied a forum to question management, and the company's credit rating stood at investment grade until just four months prior to failure.

Fairfax -- which stands for Fair, Friendly, Acquisitions -- is one of the most complicated, and least understood publicly traded entities in Canada. It has acquired a portfolio of firms since 1985, making it a major player in North American property and casualty insurance, reinsurance, insurance distribution, claims adjustment and asset management.

The company and its publicity- shy chairman Prem Watsa have treated investors to a spectacular 13 years of returns with return on equity reported at more than 20% in each of these years except two in the early 1990s. Those who love Fairfax regard Mr. Watsa as the Warren Buffett of Canada.

But those who have sold short roughly 20% of the company's stock say the comparison to the "Oracle of Omaha" is absurd, and are convinced investors and regulators should zero in on Fairfax's parallels to HIH instead.

Fairfax's stock and financial strength have been under siege since it listed on the New York Stock Exchange earlier this year. Its non-investment credit rating has been downgraded by five agencies in 2002, and a few brave equity analysts prepared to suffer the ire of Mr. Watsa have questioned everything from book value to the strength of reserves and to the billions of "reinsurance recoverables" listed as assets.

Parallels to HIH are numerous, but no matter how many off-the-record critics reveal their concerns to the Post -- and write them gingerly in reports -- the record is clear that no one is alleging Fairfax is breaking any laws or contravening Canadian Generally Accepted Accounting Principles.

What the critics do say about Fairfax is best equated to an oft-quoted statement in the Australian Royal

Commission report on the failure of HIH: "Most of the instances of possible malfeasance were born of a misconceived desire to paper over the ever widening cracks that were appearing in the edifice that was HIH."

Here 10 ways to look at HIH's demise that might give investors a new way to track Fairfax's fiscal health, lest it follow down the same path as our short seller seems convinced will happen. The market, and time, will tell whether his bet will pay off or if Fairfax will dispel each and every perceived parallel and hand him a fat loss for his misplaced concerns.

1. CALIFORNIA DREAMING

HIH lost its shirt by re-entering the California market, and taking on workers compensation policies written in the 1980s that suffered from low premiums and higher than expected claims. The misstep cost it roughly A$620-million.

The company then acquired Australia's FAI Insurance, and while it managed to benefit from non-insurance assets in the short run, it eventually got burned to the tune of A$530-million because of under reserving in FAI's "long tail" portfolio. Basically, reserves were insufficient to pay workers compensation or medical malpractice claims, because the premiums were paid in the 1980s, and the claims didn't emerge until the 1990s.

Finally, HIH formed a joint venture with Allianz, and a cash flow crisis emerged because A$500-million was locked in a trust that was set aside to handle claims. Also, the joint venture, called the "harbinger of doom" by the Royal Commission was saddled with a deteriorating claims portfolio.

"The result was predictable: it ran out of cash," read the Royal Commission report.

Fairfax also ventured into California in 1999 -- marking the tail end of its acquisition drive that saw 11 acquisitions in the 1990s and the addition of US$17.7-billion to its portfolio investments -- with the US$842-million purchase of TIG Holdings Inc.

TIG has proved a disaster thanks to higher than expected medical malpractice and workers compensation claims that in 2002 resulted in "additional development" of TIG's reserves to the tune of US$214 million.

At the end of 2002, TIG had a negative surplus of $356-million and state regulators, while allowing the company to pay a $1.2-billion dividend to its parent, have yet to allow the dividend released from a trust. This means that not only is TIG losing money -- and dragging overall underwriting results for the group deep into the red -- but its assets including the majority ownership of Odyssey Re, are locked in a trust and unable to feed any dividends to Fairfax.

"Fairfax could easily end up with substantial additional asbestos exposure and not be allowed to "extract" assets necessary to increase liquidity levels at the holding company," wrote John Gwynn at Morgan Keegan.

Fairfax has tried to shore up its liquidity with a couple of debenture issues, and its Crum & Forster Holding Corp. sold US$300-million in 10 3/8% notes in a private placement a few months ago, that were priced about 600 basis points above comparable securities. Neither of Crum's subsidiaries have dividend capacity, so it had to put US$63.1-million in escrow to guarantee the first two years of interest payments.

2.INSUFFICIENT RESERVES

Liquidators estimate HIH failed to put aside as much as A$4.3-billion for future claims, and the Royal Commission determined that this in and of itself was the group's biggest failure.

Rating agencies, equity analysts and short sellers have opined on numerous occasions that Fairfax faces a similar problem, although the company sharply criticized a report in January this year by Morgan Keegan that pegged this deficiency at US$5-billion -- an estimate that was later scaled back to US$2.4-billion.

CIBC World Markets analyst Quentin Broad wrote in a June report that "we are still reluctant to pay full price for book value as it remains to be seen whether the reserve issues are truly behind this company."

Many are still nervous that asbestos claims will force Fairfax to add to reserves, considering that a Standard & Poor's report said 27 insurers, including Fairfax, had under-reserved for asbestos, although Fairfax didn't increase reserves for this potential liability in 2002.

"It's still a concern and an area we will never get 100% comfortable with given the complexity of analyzing reserves," said Matthew Coyle, an analyst with Standard & Poor's.

"But the company has taken a lot of action to strengthen the balance sheet over the past several years, and the question is, has it been enough?" added Mr. Coyle.

3. HOW RECOVERABLE ARE REINSURANCE RECOVERABLES?

Insurance companies try to offset the risk of future claims by buying insurance from reinsurance companies. The problem with this is that when actual losses are realized, the reinsurer bickers with the insurer over who is on the hook and for how much, and the reinsurance gets reduced due to fine print and technicalities.

Reinsurance receivables factored prominently in the balance sheet of HIH, amounting to as much as A$1.8-billion in June 30, or roughly double shareholders' equity of A$927-million.

"You knew HIH was sick because it had reinsurance recoverables at twice its capital," says our offshore hedge fund manager with a near obsession with troubled insurers.

Fairfax's reinsurance receivables are listed on its balance sheet at a whopping $12-billion, or roughly 3.5 times its shareholders' capital, and are roughly 25% of total assets. On a net basis they drop to $7.4-billion.

"This is a big number. It would be a problem if some of that was not collectible," said Jarmo Saari at Dominion Bond Rating Service.

"But it's hard to quantify. Reinsurance by nature is international. The company has been accused in the past of not being transparent or open, so they are having quarterly conference calls. They can't turn us all into actuaries, because its not a simple process," added Mr. Saari

Fairfax's reinsurance recoverables represent 34% of its assets, while Chubb lists these assets at 11% and Safeco has only 2% of assets as reinsurance recoverables, notes independent debt rating firm Egan Jones Ratings Co.

"We have become concerned about Fairfax's reinsurance assets and liquidity at the parent level," reads an Egan Jones report.

Depending on the structure of reinsurance, it can be used to assist in deferring the reporting of some losses."

Mr. Gwynn at Morgan Keegan sums up the concern by saying "while it is quite common for a primary insurer with principally long tail liabilities to have reinsurance recoverables on its balance sheet that represent 100% to 150% of net worth, Fairfax's ratios of 425% gross and 246% net are extraordinarily high."

4. "FINANCIAL REINSURANCE" AND THE PADDED BALANCE SHEET

One of the murkiest parts of an insurance company's business is something called financial or finite reinsurance, that acts more like a bond in that no risk is transferred, and it has the effect of boosting reserves and smoothing profits. More often than not, these contracts are drafted in offshore locations like Bermuda.

"Its balance sheet is a work of fiction, padded by loans masquerading as reinsurance," wrote The Australian newspaper about HIH.

The Royal Commission found that HIH structured reinsurance to allow the deferral to later years of premiums paid to obtain the recoveries. "The effect of these arrangements was that the extent of FAI's under-reserving problems was concealed."

Mr. Gwynn said "our concerns with reserves and deferred tax assets are only deepened by the high degree of financial leverage at the holding company, including the significant use of off-balance sheet funding mechanisms in the form of finite reinsurance.

The company's fund withheld account is "quite large...and reflects the heavy utilization of off-balance sheet funding via finite reinsurance treaties ... rather than being classified as reinsurance (risk transfer) these treaties are more correctly viewed as off balance sheet funding vehicles," wrote Mr. Gwynn.

Fairfax has benefited from a $1-billion reinsurance deal with Swiss Re, giving it a boost to earnings and surplus in exchange for paying for the benefit over a number of years through a funds-withheld account.

And while the company's filings are not clear, the aforementioned short seller believes the company has US$500-million finite reinsurance with its U.S. Fire unit, US$100-million at North River, and US$200-million at TIG that has smoothed earnings to the tune of about $100 per share.

"Now my basic allegation on Fairfax is that it is utterly laden with finite reinsurance risk of about $1.6- billion," said the self-professed short seller.

"The sellers of this are strong companies with stable ownership structures. The buyers are weak companies that want to spiff up their accounts," he added.

5. WHEN ASSETS ARE ILLIQUID OR ILLUSIONARY

"It is a truism that a company prospers in the market only if it is financially viable and likely to attract support," read the Royal Commission report.

HIH increasingly relied on intangible assets to support shareholders equity (assets minus liabilities) including goodwill, future income tax benefits and deferred acquisition costs. Intangibles were 23% of shareholders' equity in 1997, climbing to 60% by June 30 1999, and 75% by June 30 2000.

In contrast, Fairfax's shareholders' equity of $3.8-billion would drop by more than half if future income taxes of $1.15-billion, goodwill of $279-million and deferred acquisition costs of $499-million were stripped from the

balance sheet.

Future income tax assets are only valuable if the company makes offsetting earnings -- and as $1.1-billion of Fairfax's tax assets lie with its money-losing TIG subsidiary it might take some time to recoup this asset.

Also, the goodwill balance is almost entirely due to Lindsey Morden, and it's worth noting that goodwill of $251-million for this subsidiary is almost triple the company's market capitalization of $87-million.

"When times get tough it is difficult to convert intangibles to cash; as other sources of cash disappear, the intrinsic value of intangibles is seriously called into question," said the Royal Commission report.

6. A PUBLIC COMPANY RUN LIKE A PRIVATE COMPANY

HIH was described in a 1995 due diligence report as a "company which has not yet made a complete transition from an entrepreneurially run company influenced by senior management ... to that of an [Australian Stock Exchange] listed company run primarily in the interest of shareholders."

Company and management's personal funds were often intermingled, and shareholders ended up paying for things like personal taxation advice to executives.

Fairfax only recently began holding quarterly conference calls, and defers questions to its annual meeting and annual reports.

Mr. Watsa controls the company through a dual-share structure with unequal voting rights. He actually owns just 12.9% of all classes of outstanding shares. His investment company, **Hamblin** Watsa, manages all the subsidiaries' cash, and recently tripled its fees to 0.3% of assets under management from 0.1%. The chairman and chief executive roles are both controlled by Mr. Watsa, while the board of directors consists of four members, two of whom are presidents of private financial firms.

Fairfax still has $7.6-million in zero-interest loans outstanding to seven corporate officers, although it pays the bank a rate above the prime lending rate for the money, and at one time had loaned employees as much as $19.1-million.

7. NO STRATEGIC PLAN

"In the absence of a framework within which investment and other decisions can be evaluated, the growth of the company was opportunistic and lacking in direction," complained the Royal Commission.

"A board that does not understand the strategy may not appreciate the risks. And if it does not appreciate the risks it will probably not ask the right questions to ensure that the strategy is properly executed."

The strategy at Fairfax is one of making money for shareholders, and is best revealed in its 1987 annual report: "Ours is simply to achieve a 20% return on common equity over the long term. We have no long-term plans other than to react to opportunities on a day to day basis."

8. NO DISSENTING OPINIONS

"We can't invite the whole market to a presentation, and there are some people it is just not worth inviting," said an HIH spokesman when asked why three equity analysts were barred from an HIH presentation in September, 1998.

Fairfax lashed out at reserve calculations generated by Morgan Keegan, and has blamed a battered stock price on short sellers, which by nature are a vote against a company and its management.

The stock has recovered of late, rising with the broad market for a return this year of 67.6%. The shares reached as low as $70.44 in March before peaking at $242.02 on July 31. They closed yesterday at $203, down 2 cents.

Fairfax also severed its relationship with Fitch Inc. after the debt rating agency became the fifth firm to downgrade the company's debt.

Standard & Poor's has since become the only rating agency to upgrade Fairfax when it revised its outlook from "negative" to "stable" on August 26.

On the other hand, a positive report was issued by Ferris Baker Watts Inc. saying that Fairfax was an "unparalleled value opportunity." Those comments were followed by Ferris's participation in a US$200-million convertible debenture offering in May, 2003.

9. CASH GRAB AT THE END

"In the dying days of the corporation, millions of dollars flowed to a favoured few," said the Royal Commission report on HIH.

Fairfax is by no means dying and there is no evidence management is making out like bandits. The company

did triple its money management fees charged to subsidiaries as of January, which happens to be the only cash the holding company stands to receive in 2003 from at least three of its U.S. insurance units.

Critics might point to the fact Mr. Watsa's pocketbook is fatter by about $4.3-million just from a recent decision to pay a dividend on the shares for the first time in 17 years. But, here again that policy is also something that has benefited the firm's other investors.

10. SELL THE BEST TO STAY AFLOAT

HIH started to sell off assets at the start of 2000 including the sale of its stake in telecom firm One.Tel for about US$35-million, part of its business in Argentina, and shareholdings in a number of other companies. It then shocked investors by announcing a deal to sell its best asset -- its personal lines insurance -- and its stock subsequently tanked.

In a move to shore up liquidity, Fairfax took its Northbridge Financial subsidiary public earlier this year, selling a 29% stake. Northbridge is one of the few North American subsidiaries that makes money underwriting insurance, and outside of the company's offshore entities is the only real source of Fairfax Financial's dividend.

Fairfax also attempted to take public its Crum & Forster division in the U.S. in 2001, but failed, presumably as investors realized what was later revealed in a convertible debenture offering -- that Crum & Forster's main business units are unable to pay dividends to the parent because of shortfalls in statutory surplus accounts set aside to pay future claims.

In lieu of an IPO, Crum & Forster issued US$200-million of convertible debentures with Ferris, Baker Watts Inc. part of the three-member selling syndicate.

The division also sold a further US$300-million of debentures, in July.

HIH was also an adherent to the use of these quasi-debt instruments, presumably to allay the fears of already skeptical debt rating agencies, and to prevent shareholder dilution.

"HIH attempted to allay the fears of the rating agencies by issuing subordinated debt with quasi equity characteristics because it hoped to neutralize rating agencies' concerns about its indebtedness, while also addressing shareholders' concerns of dilution by a straight equity issue," said Bonnie Buchanan, professor at University of Georgia in an analysis of HIH.

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Color Photo: Stan Honda, National Post / Publicity-shy Prem Watsa, chief executive of Fairfax, has an intense dislike of short sellers.; Chart/Graph: Bloomberg News, National Post / **FAIRFAX FINANCIAL** HOLDINGS INC.: FFH/TSX: Oct. 21 close: $203.00 -2 cents, Volume: 24,125: (See print copy for complete chart/graph.)

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