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The Reliance Shuffle

Dividend Cut?

Meet the Enemy

RELIANCE GROUP HOLDINGS IS in a bind, and it's going to need some fancy maneuvering to get out of it.

In the August issue of *Schiff's Insurance Observer* we explained why Reliance, which is in dubious financial condition, was extremely vulnerable to a rating-agency downgrade. In September, in this publication, we noted that Reliance's stock, then 4½ (down from 19⅛), gave the company a market cap of $516 million—yet Reliance's bonds were under water and trading at a 13.5% yield to maturity.

The situation at Reliance has worsened. The stock market—admittedly, a suspect short-term indicator—has marked Reliance's stock down more (it hit an all-time low of 3¼ on Thursday before rebounding to 4 on Friday). The bond market, which tends to be more rational, is less optimistic: it's saying that Reliance's stock is essentially worthless. Reliance Group's 9¾% Senior Subordinated Notes due November 15, 2003 closed at 80¼, giving them a 17.7% yield to maturity—an 1,100 basis-point spread over Treasurys, and a price that implies insolvency.

Since the bonds are senior to the stock (but subordinate to policyholder obligations), we question whether anyone should purchase Reliance's stock rather than its bonds. If Reliance Insurance Company doesn't fail and Reliance Group makes good on its debts, one would almost double his money on the bonds. (In theory, if Reliance's business is worth $710 million, the bonds would be money good while the stock would be worth nothing). Even if Reliance Group is solvent, the stock would have to double over the next four years to equal the returns available from the bonds. Although Reliance Group pays a fancy 32¢ per share dividend on its stock, it can ill afford the $37-million annual cash outflow this entails. Companies that are strapped for cash tend to cut their dividends. Reliance, of course, would prefer not to cut its dividend—for at least two reasons: 1) Steinberg's family receives $16 million a year in dividends, and 2) cutting the dividend would be an admission that the company is in weak shape.

For Reliance to continue its dividend it must either borrow money, issue securities, or (as has been the case in the past), upstream payments from struggling Reliance Insurance Company. As a result, Reliance Group's dividend cannot be considered secure, and there's a good likelihood that it will be reduced or eliminated.

As for Reliance's bonds, Steinberg doesn't have the option of reducing their interest payments.

Conditions at Reliance have become so precarious that A. M. Best, which very much *does not* want to pull the plug on the company, has (finally) taken action. On October 21 it gave Reliance a written tongue lashing: it placed the company's A- rating "under review with negative implications."

In its brief commentary, Best couldn't help but note what has been evident for quite a while: that Reliance Group will have to refinance over $500 million of holding-company debt next year ($230 million of which matures at the end of the first quarter); that Reliance is exposed to significant financial risk as a result of its Unicover fronting deals; that Reliance's surplus has declined due to operating losses and "unrealized losses on its sizable stock portfolio"; that "Reliance's financial flexibility has deteriorated further"; that Reliance will have to try to raise additional capital; and that "capital market conditions have worsened."

Despite this bounty of negatives, Best maintained Reliance's "A- (Excellent)" rating. According to Best, this reflects the company's "commitment to improving surplus levels…and refinancing its senior and bank debt in a timely manner." Best also said it expects Reliance to "exhibit stronger underwriting results next year as its commercial specialty businesses resume their historical profit trends." (We haven't noticed any historical profit *trends* at Reliance, and we don't anticipate improved industry results next year.)

Finally, Best said that it expects to complete its review of Reliance during the first quarter (by which time it should be clear whether Reliance has refinanced and raised capital). Sadly, Best's time frame is of little use to insureds who would like a more discerning opinion of Reliance's current financial condition.

We've said this before and we'll say it again: if an insurance company is hanging on to the ropes and has to raise a big wad of capital in order to *maintain* its A- rating, then it stands to reason that it doesn't deserve an A- rating before it raises the capital. (According to Best, companies with an A- rating have "excellent financial strength, operating performance, and market profile," as well as "a strong ability to meet their ongoing obligations to policyholders.")

It Looks Like Rain

It's an irony of finance that it is generally easiest to raise capital when one doesn't need it. As Samuel Insull, the Roaring Twenties' financier whose leveraged utilities holding empire subsequently collapsed, once noted, "Bankers will lend you umbrellas only when it doesn't look like rain."

For more than three decades, Saul Steinberg, the financial conjurer who controls Reliance, has been adept at borrowing umbrellas—and convincing people to give him their umbrellas. Steinberg has issued securities, made acquisitions for overvalued paper, done exchange offers, refinanced debt, juggled assets, used innovative accounting, and, often against what looked like long odds, managed to keep his leveraged insurance empire propped up so that he could get a $9,000,000 salary last year. (His brother Robert got a little less.)

Right now, however, Steinberg

reminds us of the L'il Abner cartoon character, Joe Btsfplk, who always had a rain cloud over his head. Reliance Group is dangerously overleveraged, its ratings are precarious, its debt is coming due, and insurance pricing is as soft as putty. Exacerbating matters, the end-of-the-year renewal environment should be especially difficult for Reliance. It will have a tougher time retaining good business and getting price increases than stronger insurers will. (We don't think an insured should purchase a policy issued by Reliance Insurance Company if reasonable alternatives are available from more prudently capitalized companies).

As usual, Steinberg has something up his sleeve: he thinks the stock market hasn't "fully recognized" the value of Reliance's surety and fidelity operations, so Reliance has formed Reliance Surety Group, Inc., a holding company that will operate the surety and fidelity business. Reliance Surety plans to sell up to 20% of its common stock in an IPO. Potential buyers of this IPO would be wise remember that Steinberg is a master at issuing overvalued securities. In 1986, for example, Reliance Group issued $150 million of stock at $10 per share, and in 1993 it raked in another $200 million by issuing stock at $8 per share. (The registration statement for Reliance Surety is supposed to be filed by the end of the month, and should make for interesting reading—especially the "Risk Factors" section.)

Reliance's surety business is notable among Reliance Insurance Company's operations in that it makes an underwriting profit. In 1997 and 1998, written premiums were $176 million and $204 million, respectively, and underwriting profits were $38 million and $54 million. (Excluding surety and fidelity, the rest of Reliance's insurance operations generated underwriting losses of $69 million and $106 million.)

Reliance's surety and fidelity business is a *division* of Reliance Insurance Company, and virtually all the Reliance companies are part of the Reliance pool. As a result, they benefit—or suffer—from the financial results of the pool. It will be intriguing to see how Reliance Surety attempts to disentangle itself from the woes of its parent. We suspect that any plan that walls off assets (the good-company/bad-company approach), will not be viewed favorably by regulators or litigious competitors.

Some questions: How will Reliance capitalize Reliance Surety? Will the Reliance Pool act as a front and reinsure the surety and fidelity business into Reliance Surety? Can Reliance Surety's insurance company maintain an A- rating independent of Reliance Insurance Company? Finally, what is Reliance Surety worth?

We'll take a stab at the last question. In the past three years, Reliance's surety business has averaged a $42-million underwriting profit. One presumes that Reliance Surety will earn investment income on the assets offsetting its unearned premiums and loss- and loss-adjustment reserves. In addition, it should earn money on whatever capital is contributed. To further simplify our calculations, we'll be a sport and say that the surety market isn't cyclical and that intense competition won't drive profitability into the sea.

So let's say that Reliance Surety Group will earn $60 million pretax and $40 million after tax. (Whatever the profits actually are, it's worth remembering that, in the past, they were *included* in Reliance Group's results. Reliance Group *will not create one penny of economic value* for itself by selling part of Reliance Surety Group to the public unless it sells it to the public for more than it's worth.)

CNA Surety, the only public company comparable to Reliance Surety, trades at about ten times earnings. If Reliance Surety—which is saddled with a tremendous negative: it's controlled by Steinberg—trades at a similar multiple, it would be valued at $400 million.

Accounting Magic

In theory, Reliance Group's valuation already includes the implied $400-million valuation for Reliance Surety (e.g. the surety business is an asset and some of Reliance's other business are liabilities). Steinberg, however, is hoping to alter the public's perception of Reliance Group's value. "The IPO will unlock this value," he declared, "and, at the same time, enhance our capital base."

For the moment, let's assume that Reliance Surety completes its IPO and achieves a $400-million valuation. Let's also assume that, post-IPO, Reliance Surety has a book value of $200 million. We suspect that Steinberg, who knows how to make tin look like gold, will have Reliance Group carry Reliance Surety on the *equity* basis rather than on a *consolidated* basis. This would have no economic impact on Reliance Group's intrinsic value, fundamentals, or earnings, but it would—through the magic of Generally Accepted Accounting Principles—enlarge Reliance Group's reported book value by about $200 million.

Reliance's legerdemain does not end here. The board has also approved a preliminary plan to *unlock more value* by spinning off 10% of the common stock of "a new e-commerce company," Point,

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Click & Bind, Inc., that will comprise the business of CyberComp, Reliance's "Internet-based writer of workers' compensation insurance policies for small-sized companies." Reliance's press release noted that CyberComp generated $81 million in gross premiums in 1998 and $71 million in the first half of 1999. The press release didn't say how much money CyberComp lost. (We're assuming that if CyberComp made money, the press release would have noted that.)

Reliance's spin-off strategy calls to mind James Ling's "Project Redeployment," the scheme employed by ill-fated LTV in 1965. As Robert Sobel later wrote, "The putative reason for this unusual procedure had almost nothing to do with efficiencies, management, or improvement of internal growth, though years later Ling would claim all of these had been involved. Rather, he planned to shuffle his holdings to provide each with greater visibility and *boost the price of their paper*…[emphasis added]."

The Reliance Surety and Point, Click & Bind transactions aren't Steinberg's first foray into the spin-off game. In 1968, his computer-leasing company, Leasco, used a grab bag of overvalued securities to acquire the much larger Reliance Insurance Company. Leasco, the holding company, eventually changed its name to Reliance and, in 1979, an incarnation of the old Leasco was spun off to Reliance shareholders.

The new Leasco then proceeded to buy Reliance, and Steinberg eventually took the whole shebang private in a leveraged buyout financed with debt and preferred stock. Reliance's 1986 IPO—underwritten by Drexel Burnham Lambert courtesy of Mike Milken—was intended to generate funds to repay the debt incurred from the LBO. Reliance planned to raise $320 million to $380 million by issuing 20,000,000 shares priced at $16 to $19 apiece. In addition, Steinberg and his family planned to unload 4,300,000 of their shares. The market, however, wasn't receptive to this ploy, and the IPO had to be cut back to 15,000,000 shares priced at $10 each.

If Steinberg does pull off his variation of Project Redeployment, we wouldn't be surprised to see a whirlwind of complex transactions follow. Perhaps Reliance Surety or Point, Click & Bind will attempt to exchange some newly-issued convertible preferred and a package of warrants for Reliance Group's debt. The possibilities are endless.

Back in 1994, Saul Steinberg gave an impassioned speech at the Professional Liability Underwriting Society's annual conference. In his nasal whine (uncannily reminiscent of the comedian Gilbert Gottfried), Steinberg claimed that the insurance industry faced "enormous challenges from a host of enemies." His enemies list included the tort system, the "personal injury bar," regulators and politicians, and "the arrogant and complacent attitudes of many senior executives" in the insurance business who, he claimed, had forgotten their responsibility to their shareholders—namely, earning a good return on their investment.

As far as Reliance was concerned, Steinberg didn't know what he was talking about. To paraphrase Pogo, Steinberg had met the enemy, and it was him.