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Reliance Group's Day of Reckoning

Not Dark Yet, But It's Getting There

The Reliance Surety Deal

SAY WHAT YOU WILL about Saul Steinberg, Reliance Group's chairman and CEO. He may be an overpaid wheeler-dealer, an overleveraged speculator, and an over-the-hill greenmailer—but he's got balls.

Steinberg, who is really smart—perhaps too smart—has made his money by finding value and piling on debt. Over the years his company has been a prodigious issuer and buyer of junk bonds. It has also been a big issuer of a special form of equity know as "junk stock."

In the summer of 1998, when Reliance Group's stock was approaching 20—it's now 3$\frac{9}{16}$—Steinberg could have deleveraged the company. At the end of 1998, Reliance Group had $720 million of debt and $12.8 billion of assets (at least $520 million of which were intangibles) perched atop a $1.3 billion sliver of shareholders' equity. Steinberg, who was then 59, should have done what he was shrewd enough to do when he was in his twenties: issue stock, warrants, convertible preferred, and convertible debentures. He could have exchanged Reliance's soaring shares for some of its debt and built up a balance sheet that would have been comforting when the cyclical winds of the insurance and financial markets howled at his door.

But Steinberg didn't delever when the markets were smiling at him. Why? The answer, we suppose, has more to do with psychology than finance. For at least 30 years Steinberg has placed layers of leverage upon layers of leverage, creating a delicate financial puff pastry.

Indeed, Reliance has been so leveraged that earlier this year, when Steinberg told shareholders that the *still* highly leveraged Reliance "entered 1999 with more capital and less leverage than at any time in its history," he wasn't pulling anyone's leg.

Reliance Group's strategy of applying the financial leverage of debt to the operating leverage of an insurance business with long-tail liabilities is one that would make a good case study at Wharton, where Steinberg is chairman of the Board of Overseers.

Leverage is a magnifier: it makes good results better and bad results worse. Steinberg knows this, and yet, for some reason, didn't raise enough capital when the easy money was available. Now that Reliance has been pummeled and is facing the specter of a rating-agency downgrade that could put it out of business, Steinberg is seeking capital and resorting to the financial legerdemain of spin-offs and asset shuffles.

Although we won't be there while Donaldson, Lufkin & Jenrette and Bear, Stearns attempt to peddle shares in newly-formed Reliance Surety Group, we imagine that they'll pitch the deal as an opportunity to get in at a bargain price because Reliance Group—alas—is strapped for cash.

Reliance's Debt Yields 22%

Donaldson, Lufkin & Jenrette knows a thing or two about Reliance; it was the lead underwriter in the company's 1993 refinancing. Reliance's 9% Senior Notes due next year and its 9¾% Senior Subordinated Debentures due in 2003 closed at 88 and 77, respectively—prices that say that bond buyers have serious misgivings about Reliance's solvency. (A buyer of the senior notes would make 22% in a year if Reliance Group makes the interest and principal payments when they come due.)

Bondholders and stockholders would probably feel better about Reliance had Saul Steinberg and his younger brother Robert not received $38,000,000 in salary over the last three years (this figure does not include options). On the other hand, bondholders and stockholders who feel disappointed by the collapse of Reliance's bonds and stock have only themselves to blame. Saul Steinberg has been overpaid for ages, and his corporate strategy of rapid growth, leverage, and concentration of risk has looked dangerous for ages.

As for Reliance Surety, it certainly *appears* far more desirable than Reliance Group. But appearances can be deceiving. While there are those who will see in Reliance Surety a stock worth buying, we see a Trojan Horse—an insurance company with Saul Steinberg inside.

Caveat emptor.

Read the Risk Factors

Reliance Surety's financials don't differ materially from the estimates we made in our October 25 issue (prior to the filing of the S-1 registration statement). Some details of the deal and its structure are intriguing, however.

Since Reliance is in weaker financial condition than its peers, that poses a bit of a problem. Reliance's insurance companies are currently rated A- (Excellent) by A. M. Best. "If the Reliance Insurance companies' A. M. Best rating were downgraded for any reason, it could have a *material adverse effect*" [emphasis added] on Reliance Surety's business, says the company's prospectus.

What might this "material adverse effect" be? Not much, really—other than the "effect" that people wouldn't do business with Reliance Surety.

Reliance Surety has attempted to protect itself from such a circumstance. "In the event of a downgrade of the Reliance Insurance companies," notes the prospectus, Reliance Surety "would have to rely on an arrangement with another insurer similar to [its] present arrangement with the Reliance Insurance companies. In this regard, [Reliance Surety has] entered into an agreement with a large international reinsurer rated A++ by A. M. Best, pursuant to which that company has agreed for five years to act, when [Reliance Surety requests], as co-surety" on Reliance's bonds.

Continued

Reliance Surety hasn't provided the name of the A++ reinsurer that has agreed to step in as co-surety, nor has it said what vigorish it will have to pay for such services. One presumes that if it had to pay a material amount—whether in fronting fees, reinsurance arrangements, or something else—then that should have been disclosed in the prospectus. (Reliance declined to comment, citing the "quiet period" prior to an offering.) So the question remains, how much does an A++ rated reinsurer charge to be on call to Reliance as a co-surety for five years?

Although Reliance Surety has been quite profitable for awhile, in the insurance business good results have a tendency to give way to bad results without advance warning. Like all lines of insurance, surety is exposed to a variety of cyclical risks. "Changes in economic conditions or reductions in government spending on public works could have a material adverse effect on our business," warns Reliance Surety's prospectus.

Contract surety bonds accounted for 69% of Reliance Surety's gross written premiums. Most of Reliance's contract surety bonds are for contractors engaged in the construction of public works projects such as highways, bridges and schools.

"An economic downturn could result in financial weakness and bankruptcies of contractors, and a decline in the number of construction projects," says Reliance. "This could result in an increase in claims against us. In addition, our business volume could decline if federal, state or local governments reduce their expenditures for public works, or if less construction is undertaken."

The prospectus, of course, doesn't contain projections showing what the company's earnings—or lack thereof—might be during the next recession.

Investors who buy Reliance Surety's stock—or Reliance Group's bonds or stock—would undoubtedly expect to make outsized returns on their investments, since these investments carry considerable risk.

But what does a *policyholder* stand to gain by doing business with the Reliance Insurance Company?

Agents, brokers, and insureds should keep asking that question until they get a good answer. And Reliance Group's investors and creditors ought to consider what might happen if there is no good answer. ■

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