

INSURANCE INVESTOR

Zigging While Other Insurers Are Zagging

By Chris Roush

There's always a soft spot in my heart for the underdog or the strategy that runs counter to what everybody else is doing. These people are either crazy, or are able to see things that others can't.

Having said that, one unique way to look at property & casualty insurance investing these days is to find the underwriter who is doing something totally different than its competitors. Consider Hatboro, PA-based Penn-America Group Inc., a small P&C insurer.

With a market capitalization of less than \$75M, Penn-America should be virtually ignored on Wall Street. So why is it that it's covered by eight analysts, one more than the number of analysts that follow CNA Financial Corp., a P&C insurer with a \$7B market cap? In comparison, another Pennsylvania-based P&C insurer, Erie Indemnity Co., has a market cap of more than \$2B, yet is covered by one analyst.

Obviously, a number of analysts searching for the needle in the haystack of dismal P&C stocks have discovered something that they find enticing with Penn-America.

That appeal appears to be a contrarian strategy move made a year ago. When huge auto insurer players such as Allstate Inc. and Progressive Corp. were pouring millions into expanding their non-standard auto insurance business, Penn-America exited the line.

Now, that decision is looking smart, as auto insurers struggle with higher-than-expected claims costs and more competition than they can handle.

"It cost them a lot of money to be in nonstandard auto," said Ferris Baker Watts analyst John Keefe. "But to management's credit, they recognized early on before a lot of other companies that the survivors in the business would be Progressive and Allstate. And for anybody other than those and a few others, there's no room for a small insurance company dealing through the wholesale distribution system. They saw the future of the world, and it didn't include Penn-America in nonstandard. You've got to be the low-cost producer, or pretty close to it."

The nonstandard auto business had been hurting Penn-America's financial performance. But Keefe believes that 1999 was the last year where that move will be a drag on its earnings. He believes that the company will earn 85 cents a share this year, more than 4x the 17 cents it earned in 1999. And Keefe has a "strong buy" on the company and believes its stock will hit \$13 in the next year.

So far, however, other investors have failed to recognize Penn-America's potential. The company's shares hit a 52-week high of \$11.4375 on March 26, 1999, but fell as low as \$6.625 in January before closing at \$8.375 on March 21. In the past year, the stock is

down more than 26%.

Part of the problem, according to Friedman Billings Ramsey analyst Beth Malone, is the lack of liquidity in Penn-America stock. Buying, or selling, its shares in quantity is difficult to do without causing the price to fluctuate wildly. Some investors might not want to haggle with a company where accumulating large positions could be difficult.

While she is not as bullish as Keefe, Malone rates the stock "accumulate" and believes that Penn-America's shares will reach \$11 in the next year.

Still, Penn-America has attracted the interest of a number of big-time investors. Goldman Sachs & Co., for example, owns nearly 700,000 shares, or about 8% of the company. And Penn-America's depressed stock price might be more of a reflection of Wall Street's current hatred for P&C stocks.

At a time when it seems as if every P&C insurer is trying to turn its stock around by hoping for higher prices and every life insurer has pinned its hopes on variable annuities and other investment-type policies, it's refreshing to find an insurer swimming downstream while supposedly smarter – and definitely larger – competitors are swimming upstream.

There's more. Apparently Penn-America has also beaten back the intrusion of national P&C underwriters into its core small-town underwriting focus.

"They concentrate on the small Main Street-type customer, a barber or a small contractor or restaurant owner," said Keefe. "The typical average premiums are in the \$1,500 per year and lower range. Many of their name brand national competitors simply can't make money [at that price]. Their cost structures are not geared up to make money with low-premium type business. But it didn't suffer from trying. In 1998 and the first half of 1999, many of the larger carriers were dropping down into Penn-America's market because they were hungry for business. And they were getting blown out of the water. Just as quickly as they've entered that market, they've left."

Keefe said he is hearing such anecdotal evidence of national P&C underwriters retreating from small-market accounts from other regional insurers such as Markel Corp. and W.R. Berkley Corp.

"So as the Penn-Americas start to see more of these submissions, their underwriting is generally of a better quality because they're getting more submissions and they can afford to exercise greater underwriting discipline," said Keefe. Investing in insurance stocks also takes greater discipline these days as companies compete wildly for new business to impress the market.

Penn-America's discipline, however, was in understanding when to admit defeat when others blindly plowed ahead. And that's how an underdog may win the war despite losing the battle.

—Chris Roush is editor of SNL Securities LC's *InsuranceInvestor*, a monthly publication.

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