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Markel Corporation Research Report

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Written by: Richard M. Rockwood

Company History

Markel (NYSE: MKL) was created when Sam Markel formed a mutual insurance company in the 1920s to cover "jitneys" which were passenger cars serving as public buses. In the 1950s the company repositioned itself as a managing general agent and an independent claims service organization serving the transportation industry. In 1980 Markel created Essex Insurance which is an excess and surplus line underwriter*. In 1986 Markel went public, offering shares at \$8.33, and in the following years acquired Shand Morahan, Evanston Insurance, Rhulen Agency, Lincoln Insurance and Investors Insurance Holding.

A more complete history of the company can be found on their web site at this address:
<http://www.markelcorp.com>.

Introduction

When analyzing a company I am most attracted to ones where management truly believes in adding value for their shareholders. Markel is one such company. Markel insiders own approximately 22.1% of the company and 62% of its employees own shares in the company. They obviously believe in the company strongly enough to have a significant amount of their net worth invested in the company for the long term.

I also look further to see how a company is operated: is it willing to tolerate earnings volatility for the short-term while building value in the long run. Markel is willing to do this. For instance underwriting standards or rates are not lessened in order to sustain higher premium volumes. This can be seen in several ways:

1. Underwriting profits have been attained in twelve of the last thirteen years (excluding 2000)
2. Only once since 1989 has the GAAP combined ratio been over 100% (excluding 2000)

The part of an insurance company I look at the closest are: underwriting, how reserves are handled, and how an insurance company invests the premiums it receives. I have already discussed underwriting standards so lets examine loss reserves next.

Loss reserves at Markel are established very conservatively. Reserves are established that allow for a margin of safety, this means reserves are established which will cover large events that are certain to happen; the time the event will occur is the impossible to determine variable. This is very important because the insurance business itself leads to negative "surprises" in the business they write from time to time, this is inevitable and Markel plans ahead to cover the losses.

Investment Policy

Markel sells insurance to their customers and collects the premium from them. Markel then takes the premiums it receives from the policyholders and purchases high quality bonds.

One of Markel's competitive advantages is that they invest a portion of their investment income and underwriting profit into equity investments. Markel has two stakeholders, their policyholders and their stockholders. They invest their policyholder's money in high-quality bonds and invest their stockholder's money into equity positions that in the long run will provide superior returns. Markel has 80-85% of their net worth in equity investments.

This quote from the 1998 Markel Annual Report letter to shareholders states very succinctly how Markel approaches investing:

"We currently own no high technology or internet stocks (the valuations of which we also just don't understand). We continue our long-standing practice of careful selection and extremely low portfolio turnover as it serves our purposes of owning good companies for the long term, and maximizing the total after tax return to our shareholders".

Markel's investment portfolio has enjoyed above market returns on its investments. They achieved an impressive annual return of 26.3% on their equity portfolio (which is managed in house) and achieved a 10.5% return on their fixed income portfolio during 2000. Even more impressive however has been their performance of their equity portfolio over the last ten years: 20.4%. They handily beat the 17.4% return achieved by the S&P 500 index over the same time period.

Tom Gayner, President of Markel-Gayner, further discussed his viewpoint of investing on the January 2001 Q4 Markel Conference call:

"..looking at investments in a common sense business like fashion." "..stock is part of a business and the business is worth what the present value of the future cash flows are and nothing more or nothing less. We are investors not traders committed to sticking with that sort of approach and we did stick with it through a time when that didn't seem to be the way the market was looking at things, but last year it did.

We operate with a margin of safety in the investment portfolio."

The equity team believes in a focused approach as evidenced by this quote from the 1999 annual report:

"We concentrate our equity portfolio in relatively few securities. At year-end our top five positions represented over 32% of our portfolio and the top 20 represented 71%. While diversification might reduce short-term volatility, we do not believe it maximizes long-term total return. We believe we can earn the best returns by concentrating our focus and our portfolio in promising areas where we have the best understanding and knowledge. "

Markel's Top Five Equity Holdings as of December 31, 2000:

<u>Holding</u>		<u>Value on 12/31/00</u>
1. Berkshire Hathaway	23,813 B shares/211 A shares	\$71,037,000
2. Anheuser Busch	697,268 shares	\$31,726,000
3. XL Capital	288,747 shares	\$25,229,000
4. Centerpoint Property Trust	502,200 shares	\$23,729,000
5. Martin Marietta Materials	486,016 shares	<u>\$20,558,000</u>
	Total:	172,279,000

Markel's total equity holdings (72 positions total) had a total value of \$398,594,000 as of December 31, 2000 (this information was obtained from Markel's December 31, 2000 13F SEC filing). So Markel has 43.2% of its portfolio in its five top holdings, which qualifies in my book as a focused investor! The large number of overall positions is partially a result of not having sold the entire investment portfolio received from Terra Nova as a result of its acquisition.

Accounting Standards

Markel believes in a conservative accounting stance. In insurance businesses the important (or best) measure is not earnings per share, it is how well loss reserves are established and how strong the financial condition of the company is. Markel has a strong balance sheet focus, which is another of its competitive advantages since policyholders (or potential policyholders) and rating agencies need to have no doubts that Markel can pay claims when they come due.

Markel has often made choices that result in lower earnings per share in the short run but made economic sense for the long run. For example Markel has often significantly shortened goodwill amortization periods, which has hurt earnings in the short but built a stronger, more conservative balance sheet for the future.

Markel has announced it plans to sell approximately 1,078,940 new shares to the public in order to relieve itself of approximately \$140 million of debt. These shares have been priced at \$162.50. This would bring Markel back more in line with its target capital structure of 33% debt in relation to total capitalization. This should be considered an overall positive move even though I'm not particularly thrilled to be seeing Markel sell its shares at this price level.

Another important factor that needs to be considered when looking at the pros and cons of the new share offering is that an insurance company can not write more premiums than 2X the amount by which the value of an insurer's assets exceeds its liabilities. (i.e. their Premium to Surplus ratio). So by increasing their capital base they can increase the total gross premiums they are able to write. This is important when you consider that Markel stated during their latest conference call that they believe there may be significant opportunities to write more business (on very favorable terms) in North America going forward. Not to mention that several of their competitor's have basically dropped out of the market (i.e. Frontier and Reliance Insurance).

Acquisitions in General

Markel has completed a number of successful acquisitions in the past, see pages 7, 8, and 9 of the 1997 Markel annual report for an extensive review of this subject area. I will just make a few points in this particular area.

Markel's most important acquisition was when Shand Morahan and Evanston Insurance Company were invested in during 1987. The company was totally acquired in 1990. Markel's total investment amounted to less than \$85 million. Markel fixed its problems and in 1997 the business generated over \$100 million in underwriting premiums, a small underwriting profit, and investment income on a \$650 million portfolio.

This quote from the 1997 Markel annual report describes their feeling about acquisitions:

"We continue to believe that future acquisitions will be an important part of our growth and development. We look at many opportunities but find few that meet our requirements. We expect an acquisition to have the ability to earn underwriting profits and contribute to our goal of building book value at a 20% annual rate. In addition over the years we have developed a strong corporate culture; one we call The Markel Style. In any acquisition we expect the people involved to embrace and be comfortable with our corporate values."

Terra Nova (renamed Markel International) & Gryphon Acquisition in Particular

To date these two mergers have not produced acceptable results. Markel's management seems to have underestimated the underwriting loss the discontinued lines would produce in both, especially in the business from the Gryphon acquisition. On the positive side Markel was able to acquire Gryphon's \$300 million investment portfolio and Terra Nova's investment portfolio, which was valued at approximately \$1.5 billion in 1999.

Another very positive event to emerge from the merger was addition of Jack Byrne and Mark Byrne to Markel's Board of Directors. Jack Byrne is a legendary figure in the insurance market having for a period of years operated GEICO Insurance (now a Berkshire Hathaway company) and is currently operating White Mountain Insurance. Mark Byrne, Jack's son, operates West End Capital Management (Bermuda) Limited, a Bermuda-based investment management company. West End Capital manages approximately \$800 million in net assets, primarily for General Re, a subsidiary of Berkshire Hathaway.

Here are some comments on Markel International from its chief operating officer, Jeremy Cooke, in an article in the February 2001 edition of Best's Review:

"The Lloyd's operation has had underwriting losses of more than \$150 million in the past 18 months, Cooke said. "The business was writing in the area of a billion dollars of premium in 1999, and going forward for the year 2001, our premium ratings will be in the area of \$600 million, if that," he said. "The clear message throughout the group is to get back to core operating principles of returning an underwriting profit first and superior investment return second. Premium volume is unimportant, market share is irrelevant, and underwriting profit is crucial."

"We are very confident, with the restructuring steps we have taken over the past few months, that we are now in a position to capitalize on the talent and start to produce a meaningful underwriting profit," Cooke said. "My charge, and that of my colleagues at Markel International, is to ensure that every single product line at every single operating unit is profitable starting in the year 2001."

Future Prospects

The Q4 2001 conference call advised that the combined ratio for the company overall was a disappointing 114%. The acquisitions of Terra Nova and Gryphon have resulted in a much worse combined ratio than Markel usually produces. Markel International has produced an unsatisfactory combined ratio (118% for the nine months ending September 30, 2000) but the management has been working diligently to reduce the combined ratio by focusing on attaining an underwriting profit.

Steven Markel, Vice Chairman, stated during the Q4 2000 conference call, that the goal of having the Markel International book of business profitable by the 4th quarter of 2001 would be "an optimistic forecast." President and Chief Operating Officer Anthony F. Markel advised, "there is still some more heavy lifting to be done" to bring Markel International inline with the company expectations.

Management was much more upbeat when discussing the result of Markel's North American division (which writes surplus and admitted lines of insurance*). The division has fared extremely well so far in fiscal year 2000 producing a 97% combined ratio through September 2000. They believe the environment going forward looks great for specialty carriers. They are

seeing 10-50% increases in some business and further advised some classes of business have been completely abandoned by standard insurers. These areas include nursing homes and contractors.

The comments on underwriting performance were also positive when looking at Markel North America with expectations ranging from them staying the course or improving in 2001.

Executive Compensation

I have pulled some information from Markel's 1999 proxy statement to provide some insight on how rationally managers are compensated and to show how management has a significant stake in the company.

Stock Plans For Employees

As of January 31, 2000, 97,500 shares were available for issuance to employees of the Company and its consolidated or unconsolidated subsidiaries under the 1993 Incentive Stock Plan. It is the Company's current policy to use option and other stock award plans sparingly. No options or other awards were granted to executive officers during 1999. The company has this to say on the subject of granting options, "We have essentially eliminated the practice of granting stock options because we do not believe they encourage employees to act like owners. Instead, we have instituted stock purchase and unsecured loan plans with subsidized interest to encourage employee share ownership."

Stock Ownership Amounts of Key Personal at Markel

	<u>Shares</u>	<u>Percent</u>	<u>Contingent Value Rights</u>
Anthony F. Markel	400,916	5.45%	
Gary L. Markel	372,075	5.05%	
Steven A. Markel	543,224	8.74%	8,783
Alan I. Kirshner	108,573	1.47%	
John J. Byrne	40,107		40,107
Mark J. Byrne	15,311		15,311
Thomas S. Gayner	25,212		140

Bonus Plan For Executive Officers

Under the Executive Bonus Plan, executive bonuses, expressed as a percentage of base salary, are awarded based on a five-year average of the compound growth in book value per share of common stock. The table below shows the level of bonus paid in effect for 2000 under the Executive Bonus Plan.

Five Year Average Compound Growth in Book Value Per Share

	<u>Bonus as % of Base Salary</u>
Under 15%	0%
15%	25%
16%	40%
17%	55%
18%	70%
19%	85%

20%	100%
21%	115%
22%	130%
23%	145%
24%	160%
25%	175%
26%+	Discretionary

Loan Program

Since 1993, the Company has, from time to time, offered a loan program to all employees and non-employee directors to facilitate the purchase of shares of the Company's Common Stock (the "Loan Program"). As part of the program the Company has offered to refinance similar loans the Company had made previously. The Loan Program also provides for the award of bonus shares to participants at the rate of one bonus share for every 20 new shares purchased in connection with the Loan Program. In 1998, a new restricted bonus feature was added which awards bonus shares at the same one for 20 share rate, but the restricted shares vest 20% a year

All loans made under the Loan Program bear interest at 3% and are generally due and payable within 10 years of the loan date. The unsecured loans are full recourse and are partially amortizing, requiring a balloon payment at maturity in the case of Messrs. Gayner and Martin, and are fully amortizing in the case of Messrs. Grandis and Kasen. The loan may be prepaid at any time, must be repaid in the event of an employee's termination, or in the event a non-employee director ceases to be a director, and the interest rate and payment terms are adjusted to terms comparable to market rates and terms in the event a participant sells or pledges the shares purchased pursuant to the Loan Program (including bonus shares awarded in connection with the Program) without the Company's prior consent.

Company Strategy**

In order to meet our financial goals of consistent underwriting profits and superior investment returns to build shareholder value, we have set the following objectives in managing our business:

- To maintain a leadership position in the specialty insurance market;

By focusing on specialty markets where customers have specialized needs we seek to add value through strong customer service and underwriting expertise. We believe this enables us to compete on a basis other than price. Markel North America is the fifth largest domestic excess and surplus writer in the United States as measured by direct premiums written. For the 2000 year of account, Markel Capital was the fifth largest capital provider at Lloyd's with \$454 million of capacity, net of commission.

We believe the acquisition of Markel International provides us with additional opportunities to grow profitably in specialty insurance markets on a worldwide basis. Markel International writes specialty property, casualty, marine and aviation insurance on a direct and reinsurance basis. Business is written worldwide with the majority coming from the United Kingdom and the United States.

- To earn consistent underwriting profits by focusing on specialty insurance and market niches where we have underwriting expertise

We have reported underwriting profits in 12 of the last 15 years. Markel North America continuing operations has reported underwriting profits for 14 of the last 15 years. We believe the ability to achieve consistent underwriting profits demonstrates knowledge and expertise in our niche markets, commitment to superior customer service and the ability to manage insurance risk. In all of our markets we seek to compete by developing specialty products to meet well-defined market needs and by maintaining relationships with brokers and insureds who rely on our expertise.

Since our acquisition of Terra Nova, we have made significant strides in refocusing Markel International on underwriting profitability. In an effort to refocus Markel International, we have reduced eleven underwriting units to five; we have established a new management team in one location; underwriters' bonuses are now based on underwriting profitability and exclude consideration of investment income; we have reduced staff from approximately 775 to 567; we have formed a run-off unit to focus on discontinued lines; and we have centralized investment, accounting and actuarial functions. For the year ended December 31, 1999, the last full year of control by prior management, Markel International controlled gross premium volume of approximately \$1 billion. As a result of our aggressive focus on reunderwriting and accepting only profitable business, Markel International's full year 2000 gross premium volume dropped to \$705 million and we anticipate 2001 gross premium volume of \$600 to \$650 million at Markel International.

- To offer a broad array of specialty products through many different methods of distribution

Our combined operations offer over 85 different products, no one of which represents more than 7.5% of gross written premium. This allows us to enter and exit product lines quickly and opportunistically in order to achieve our underwriting profitability goals. We offer our products through retail agents, wholesale brokers, direct marketing and the Internet. Because of our wide range of distribution channels, we are able to choose the method of distribution that maximizes our opportunity to earn underwriting profits.

- To achieve superior investment returns

Our five and ten-year weighted average annual return on our total portfolio at December 31, 2000, was 8.4% and 8.9%, respectively. Our five and ten-year weighted average annual return on our equity portfolio at December 31, 2000, was 16.0% and 16.8%, respectively. Approximately three-quarters of our investable assets come from premiums paid by policyholders. Policyholder funds are invested predominately in high quality corporate, government and municipal bonds with relatively short duration. The balance, comprised of shareholder funds, is available to be invested in equity securities, which, over the long run, have produced higher returns relative to fixed income investments. We seek to invest in companies with the potential for appreciation and hold these investments over the long term.

- To establish loss reserves which are more likely to prove redundant than deficient

Our Markel North America operations have reported reserve redundancies for each of the past ten years. We continually review our business and seek to assure that the reserves we provide are more likely to prove adequate to meet future exposure than to be deficient. Current loss estimates affect not only current financial results, but also influence many pricing and risk selection decisions. If we are conservative in our approach to setting current estimates, then future decisions based on those estimates should also be consistently conservative.

- To align employee interests with those of shareholders through our compensation policies

Our executives' incentive compensation is tied to our compound growth in book value. We believe that growth in book value per share is the most comprehensive measure of success due to the fact that it includes all underwriting and investing results. A portion of the incentive compensation available to all employees is based on unit profitability and our achievement of our growth in book value goals. Moreover, our underwriters have the opportunity to receive significant cash bonuses based on underwriting results, and their underwriting results do not consider investment results. All of our North American employees receive a portion of their 401k contributions in the form of our common shares. We have essentially eliminated the practice of granting stock options because we do not believe they encourage employees to act like owners. Instead, we have instituted stock purchase and unsecured loan plans with subsidized interest to encourage employee share ownership. At December 31, 2000, we estimate that at least 62% of our associates own some common shares and that total associates' ownership, including executive officers and directors, is approximately 22.1% of our outstanding shares.

- To build shareholder value by growing book value per share.

We assess our effectiveness in building shareholder value through the measurement of growth in book value per share. We recognize that it may be difficult to grow book value per share consistently each and every year, so we measure ourselves over longer periods of time. Our goal is to grow book value per share by an annual compound growth rate of 20% measured over a five year period. For the five and ten years ended December 31, 2000, our book value per share has grown at a compound annual rate of 21% and 26%, respectively. As adjusted to exclude the benefit of issuing equity securities in the Terra Nova acquisition and to exclude the goodwill amortization costs resulting from that transaction, our five and ten-year compound rate of growth in book value per share was 16% and 23%, respectively.

Conclusion

Markel is a very interesting example of a well-run company with extremely high-quality management that focuses on creating shareholder value over the long term. Is it suitable for possible investment? I will leave that for the readers to decide after reading this report and conducting their own due diligence.

I especially want to thank Mr. Bruce Kay and Mr. Thomas Gayner of Markel for their comments on this report and for allowing me to discuss Markel with them. Their feedback was invaluable.

If you have any questions or comments regarding this article please contact me at focusinvestor@yahoo.com. Please join in on our ongoing discussion of Markel on the FocusInvestor.com Markel Message Board at: <http://www.focusinvestor.com/cgi-bin/ib3/ikonboard.cgi>.

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*An admitted insurer is licensed to transact insurance business in the insured's home state. A nonadmitted insurer is not licensed to transact insurance business in the insured's home state. Surplus lines insurance is a mechanism that allows United States consumers to purchase property-casualty coverage from nonadmitted insurers when consumers are unable to purchase the coverage they need from admitted insurers. Typically, three admitted insurers must decline coverage before coverage can be placed with a nonadmitted insurer. Generally, nonadmitted insurers are free from regulatory oversight of policy forms and rates. It is this freedom that permits nonadmitted insurers to provide unique coverage and rating plans that are otherwise not available to consumers through admitted insurers.

**This section was taken verbatim from Markel's SEC Form 425b5 Prospectus Supplement to prospectus dated January 24, 2001.

Examples of Coverage Lines

Excess and Surplus Lines

Casualty

- Artisan contractors
- Child and Adult care facilities
- Vacant Office Buildings
- Restaurants and Bars
- Vacant Properties
- Apartments

Marine

- Cargo
- Hull coverage
- Marinas
- Yacht Manufacturers

Property

- Earthquake
- Fire
- Hail and water
- Windstorm

Professional

- Directors' and officers' liability
- Discontinued products
- Employment Practices
- Medical Malpractice

Camp and Youth Recreation

- Dance schools
- Horses and horse stables
- Martial art clubs