Atlas Financial Holdings (AFH) — Updated Feb 2014

Atlas Financial Holdings is a well run niche insurance provider currently entering a prolonged hard market. Current valuations fail to account for a well capitalized company that prudently writes risk through the Property & Casualty insurance cycle. Insiders and management own significant stakes ensuring incentives are aligned.

Ticker:	**AFH**	**Current Price**:	**$16.83**
Action:	Long	Market Cap (M)	$205.5
Expected Timeframe:	1-3 years	Enterprise Value(M):	$163.7
Asset Class:	Common Equity	Target Price:	$30.00

Investment Overview

Atlas Financial Holdings is a commercial automobile insurance carrier that writes business primarily in taxi, livery, and para-transit lines. The company has had a tumultuous past and only recently started writing profitable business. Investors who look at historical financials and loss ratios will shun the company. Those same investors are ignoring the new company that bears resemblance to the old company in name and insurance line only.

Going forward, investors should focus on management, loss ratios since new management has joined, and the hardening market. Atlas will not become a company that writes billions of dollars of premium per year. However, at today's prices, an investor has limited downside and plenty of upside as management attacks their multi-year plan. When one looks at Atlas, they should not focus on the entire industry, but rather, the niche that Atlas focuses on. There truly is "riches in niches."

Commercial Auto Insurance

As a brief primer, the commercial auto segment is a sub-segment of the much larger Property & Casualty (P&C) industry. Commercial auto can be thought of as a more specialized property insurance product, when compared to say, homeowners insurance. Specialized insurance operations require more hands on approval of policies and analysis of claims. Within commercial auto, further sub-segments exist that require even more analysis and understanding of the market. Understanding these niches is very profitable, commercial auto has generally written premium at an 8% lower loss ratio when compared to the broader P&C industry[1].

Large generalized carriers (such as Hartford) will often look for new lines of business in sub-segments that they already operate in. If Hartford offered personal automotive insurance, they could conceivably offer commercial auto insurance using similar back-office analytics and personnel that personal automotive insurance uses. Usually these large carriers will get approached by Managing General Agents (MGA), who can offer to write large books of business very quickly. The MGA writes the business and the carrier holds the risk. Throughout the cycle, MGAs will typically write between 10-40% of all commercial auto business.

Anyone who has followed commission based businesses knows that there is an inherent conflict of interest in this relationship. If my goal, as an MGA, is to write business for a commission, I am not immediately impacted by the results of that business I wrote. Given that a MGA is a "General" agent, they are by definition a generalist and may not understand the nuances of certain specialties (this is a broad generalization, many MGAs are highly trained and specialized). In the case of commercial auto, claims processing is a nuance that requires knowledge of the industry and players.

As an example, let's say I insure a fleet of three taxicabs. If the insured fleet experiences two claims in one year, it will be up to me to determine what claims I fight. If one claim is for a simple fender bender and the taxi needs to be repaired, it is to my advantage to get the claim paid and get my client back on the road as fast as possible. If the claim is from a lawyer with a known reputation as an ambulance chaser and claims that the cab I insure hit his client 3 years ago, I should probably fight this.

Most MGAs and large carriers are trained to simply pay out the claim. The cost of fighting this claim will be large and the basic relationship of an MGA/Carrier generally doesn't allow for this. Thus claims are paid and loss ratios rise. Given the added layer of commissions and increased cost, MGA/carrier relationships typically write premium at lower expected profit and hope to make up for it on volume. In small niche specialties, this is not possible.

Understanding the commercial auto space relies almost exclusively on watching MGAs enter and exit the market. Since 2012, thanks to large underwriting losses due to reserve development (caused by bodily injury claims), commercial auto has experienced a firming of rates and an exit of MGAs. Scott Wollney, CEO of Atlas, estimates that currently 10% of the commercial automobile segment uses MGAs to write premium. This is down from 35% just two years ago. Using rough math, 1 in 4 commercial auto policies are up for grabs and the large carriers are not interested. This is great news for Atlas and the niche they operate in.

Goldilocks Market

With so many policies available and large carriers retracting, there is ample opportunity with limited capital. In other words, this is a classic set up to a sustained hard market. For Atlas, the opportunity to deploy capital slowly should reward them over the long run. According to management, more than 90 agents approached Atlas in 2014 looking to place books of business. Atlas proved only nine of them. This is a buyer's market.

However, right now it is only a buyer's market for Atlas. Other insurers are still having trouble with the commercial auto market. For instance, in the Q4 2014 conference call Selective Insurance Group mentioned "Premiums declined year-over-year as a result of our strategic non-renewal of dwelling fire policies and ***targeted non-renewal actions on underperforming auto*** and home business."(emphasis added) Selective probably walked from certain business because in Q4 2014 their commercial auto market wrote business with a 104.4% combined ratio.

Digging deeper into Selective, we can see that in 2014's 9M results, new net premium written decreased 10% and the resulting increase in net premium written was due exclusively to rate increases. In other words, Selective is not taking on as much new business and increasing the rates for old business. They are taking rate instead of giving rate. This directly opposes Atlas who is both taking rate and rapidly building net premium written through new accounts.

This is a dichotomy of the commercial auto market and one of the reasons I believe Atlas is undervalued compared to their growth rates and underwriting capability – investors are just grouping Atlas in with the rest of the industry.

To keep picking on Selective, there is a reason that this bifurcation is occurring. Selective primarily insures larger fleets (>30 vehicles, see an example here), whereas Atlas insures small fleets. With a mere 2.5 vehicles per average policy, Atlas goes places where others can't. Many small fleets are uninsurable by larger players and Atlas can provide the hands-on approach necessary for a fleet owner of 1-3 vehicles.

If I manage three taxis and one of them is in a crash, 33% of my business is no longer generating revenue. Having an insurance carrier who can quickly respond to my claim is worth its weight in gold. If I manage 150 vehicles and two are in crashes, the resulting impact to my bottom line is significantly less and I can afford to wait. A hands-on approach is necessary, and highly profitable, for small fleet insurers. Atlas though is large enough to actually achieve scale. Given the numerous fixed costs in an insurance business, a large footprint is necessary to be profitable and achieve satisfactory returns on invested capital. The ability to scale while still offering niche service is part of their Goldilocks market.

The second part of their Goldilocks market is the current commercial auto market, a segment that is characterized by firming rates, but not hard rates. Currently, the commercial auto market is seeing rate increases in the mid single digits. For instance, Selective Insurance saw a 5.8% increase in rates during the nine month period ending on September 30, 2014. Generally, a hard market is characterized by rate increases of more than 15%.

While it may seem counterintuitive, it is actually better for Atlas if rates creep up slowly. Slow changes will keep large carriers out of the business for longer periods of time. If I was a large carrier and wanted to place business in the commercial auto industry, I probably underwrote to a loss. Without really examining the business (i.e. looking at my claims policy, MGA underwriting, etc), the easiest comparison point for profitability is rate. So if rates have gone up 50%

Valuation

I believe that Atlas has a good runway to build premium, make small bolt-on acquisitions, and compound book value at better than 15% per year. Given my discussions with management, independent agencies, and competitors I have constructed the following model for Atlas over the next few years.

Table 1. Atlas Financial Estimates Source: Dichotomy Calculations

In Thousands	2014	2015	2016	2017
Net Premium Earned	$108,910	$168,841	$236,377	$319,109
Total Revenue	$112,626	$175,841	$243,377	$326,109
YoY Change	52.1%	56.1%	38.4%	34.0%
Loss Ratio	62%	56%	55%	54%
Expense Ratio	27%	26%	25%	24%
Total Expenses	$100,688	$144,189	$194,701	$254,365
Operating Profit	$11,938	$31,651	$48,675	$71,744
Net Income	**$8,954**	**$22,156**	**$34,073**	**$50,221**
EPS	**$0.73**	**$1.82**	**$2.79**	**$4.12**

Getting to a fair value is, as always, more of an art than science. Within the insurance space I prefer using a blend of price-to-book ratio and earnings multiple. Given that the hard market is forming slowly and new entrants should be a good year or two away (even if rates go vertical), Atlas should earn more than $1.80 in 2015 and well more than $2.50 in 2016. For a large general carrier I would argue that an 8-10X EPS multiple is correct as we progress towards the top of a hard market. For a niche player like Atlas (that is growing considerably faster) I believe a 10-14X multiple makes sense.

Therefore, on an earnings basis I believe that Atlas is worth $27-$33.50 per share based on 2016 numbers.

When looking at book value, a >15% ROE is required to hit a 2X price-to-book ratio. By my estimates Atlas will attain a 17% ROE in 2015 and 21.1% in 2016. While a larger book multiple could be discussed with ROE's exceeding 20%, I will be conservative and use a 2X multiple to book value. I estimate that book value will hit more than $10.40 in 2015 and more than $13.20 per share in 2016. A conservative 2016 estimate is $26.40 per share, based on a market price that is 2X book value.

Whether an individual values Atlas on an earnings basis or a book multiple basis (ignoring the fact that they are linked and two of the same) it seems clear that Atlas can compound book value and attain a fair value of shares at more than $26 per share. Given that we have not fully entered a hard market in commercial auto, Atlas should have time to compound book value. The last true hard cycle for the commercial auto sector was more than 4 years long, giving Atlas plenty of run way to work with. Management has stated that they can capture more than $400 million of business without losing control of underwriting standards, or chasing unfamiliar markets.

Another source of upside, although not explored in my model, is the potential for continued acquisitions. There are a number of regional commercial auto insurers that Atlas could acquire. Atlas has acquired Gateway and Global Liberty. While the acquisition of Global Liberty is still in early days, the Gateway acquisition has had enough time to integrate and develop claims. Thus far, Gateway has performed above expectations.

Risks & Downside

The number one risk to any insurer is poor underwriting. Atlas is no different and needs to write better business than competitors to produce above-average returns. In the case of Atlas, historical deficiency tables are of little help. Looking back to 2006 only shows us what old management was forced to do in the face of an activist forced liquidity crunch. I believe CEO Scott Wollney's background helps investors here and mitigates the chance that large black swans occur. Wollney has been in the insurance industry for more than 15 years and prior to Atlas, was a commercial auto insurance brokerage expert. He has seen both sides of the risk equation.

Furthermore, Atlas has written to a redundancy in the last two years, a period that has seen numerous companies pull back on their premium writing due to inadequate returns. In NY statutory filings, Lancer (a smaller competitor to Atlas) disclosed that they wrote a 106% combined ratio in 2013. The overall delta between Atlas and competitors is staggering and a testament to the quality underwriting that takes place.

On a share price basis, paying more than book value presents some obvious risk factors. However, I will counter that the strong growth acts as a solid backstop to downside. By my estimates, book value will grow from an estimated 2014 year end number of $8.60 to more than $17.30 by 2017. At current prices an investor is paying up for less than three years of book value growth, if my projections are in the park. Given that Atlas invests their float in investment grade products (there is no reaching for yield), there is minimal investment risk that could materially impair the book value.

Finally, these small bolt-on acquisitions could prove disastrous if Atlas acquires a company that writes poor risk. While a possibility, this seems to be mitigated by two factors. First, Atlas has been buying companies for book value, which at least provides the safety of real assets. Second, Atlas often includes an adverse development clause in their acquisition agreements. Management from the acquired firm sticks around and is highly incentivized (through Atlas shares) to write risk responsibly.

Finally, the largest risk prevention mechanism is insider ownership. Scott Wollney has told me that "literally, 99% of my net worth is in Atlas stock." It is hard to get much more bullish than that. Given his tenure in the insurance industry and previous experience, Wollney is focused on one thing and one thing only: not losing money (and inversely, making a lot of money). Collectively, executive officers and directors own more than 1.1 million shares, which I believe aligns management and outside investors.

Conclusion

Atlas Financial is a niche insurance provider to small commercial auto fleets. By avoiding larger fleets, and utilizing in-house analysis, Atlas is able to underwrite profitably throughout the cycle better than most commercial auto insurers. Currently the market is ascribing very little value to the rapid growth, quality underwriting, and large returns on equity that Atlas is achieving. Instead of focusing on Atlas by itself, the market is focusing on the broader P&C market and commercial auto market, both of which are growing slower and seeing adverse loss developments.

As legacy carriers continue to exit the market, niche, well-capitalized providers like Atlas can swoop in and grab business at advantageous rates. The company has written risk well in the past and with a fully-aligned management team, should continue to do so in the future. Currently I believe that shares are worth more than $30 per share based on a combination of earnings a book value growth. Risk factors to pay attention to are loss development, excess compensation at the mid-management level, and a change in business focus.

Sources

1. Atlas Q3 2012 Presentation
2. http://www.casact.org/pubs/forum/12fforum/captain.pdf

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