LANCASHIRE HOLDINGS LIMITED

AN INSURANCE COMPANY WITHOUT THE BLACK BOX

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Disclaimer

- These are my honest views as of today
- I have a position in Lancashire
- This isn't investment advice
- You shouldn't rely on this presentation to make investment decisions
- There is no guarantee I am right
- If you do decide to invest, do your own damn work!

What is Lancashire?

- Property insurance and reinsurance company
- Formed in 2005
- Based in London
- Insures risk worldwide
- Stock trades on the London Stock Exchange
  - Symbol – LRE
  - Stock Price as of 6/17/14 – 649 pence, $11.00
- Current market capitalization – about $2 billion

Investment Thesis

- Lancashire is dirt cheap
  - Stock trades at a little over 9X 2013 earnings and about 8.5X my estimate of normalized earnings without considering any of the upside opportunities
- Lancashire is a much higher quality company than the typical property and casualty insurance company
- Several different avenues for Lancashire to meaningfully increase earnings over the next couple of years

The Business Model of the Typical Insurance Company

- Makes little or no money selling insurance
  - Sells a commodity product
- Generates most of its profit from its investments
  - Collects premiums upfront
  - Claims are paid out months or years later
  - Can invest float in the interim
- Must use leverage to generate an adequate return
  - Average assets to equity ratio of 4 or 5 to 1
- Writes as much business as regulators will allow
  - Premiums to equity ratio may exceed 2 to 1

The Lancashire Business Model

- Focuses on insuring risks that require extensive knowledge and experience to price policies and administer claims
    - Examples: aviation terrorism, property expropriation, offshore energy
- Insurance operations are among the most profitable in the industry
- Over 80% of profits come from insurance operations
- Investment returns are gravy, not the whole enchilada
- Extremely conservative balance sheet
- Insurance underwriting profits generate attractive returns without the need for investment leverage
    - Average assets to equity around 2 to 1
    - Premiums to equity ratio of 0.5 to 1

Why are the Differences Important

- Reliance on investment returns is inherently less stable
  - Pressure to reach for yield on investment portfolio
  - Pressure to lever up the balance sheet
  - Pressure to write as much business as possible to get more float, even if business is only marginally profitable
  - Can lose significant amount of capital in a large catastrophe event

- Results:
  - Typical insurance company is a levered bet on fixed income
  - Either side of the balance sheet can blow up
  - The typical insurance company is a black box

Exceptional Underwriting Performance

Lancashire's Combined Ratio Since Inception:

	2006	2007	2008	2009	2010	2011	2012	2013	Average
Loss Ratio	16.1	23.9	61.8	16.6	27.0	31.7	29.9	33.1	30.0
Expense Ratio	28.2	22.4	24.5	28.0	27.4	32.0	34.0	37.1	29.3
Combined Ratio	44.3	46.3	86.3	44.6	54.4	63.7	63.9	70.2	59.3

- One of the most profitable insurance operations in the industry
- Profitable every year, even in years with major natural catastrophes

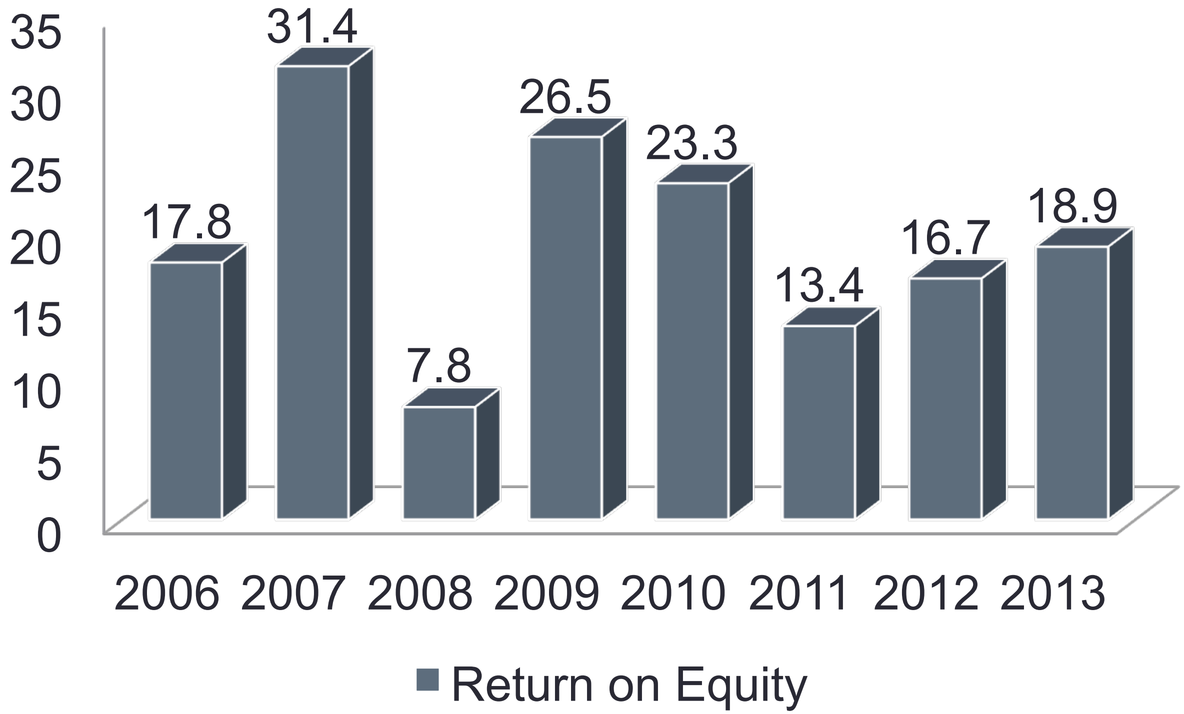
How Does Lancashire Achieve Great Underwriting Results

- Culture
- Compensation tied to underwriting profits
- Niche insurance lines that require specialized knowledge and have less competition
- Most business is short tail
  - Claims are reported and resolved quickly leading to more accurate reserve estimates
- Most business is excess of loss
  - Claims are low frequency, high severity
- Numerous uncorrelated lines of business, and they manage catastrophe exposure very well

Great Insurance Underwriting Leads to Strong Returns on Equity

Average ROE Since Inception – 19.5%

Industry Average – 7-9%



Lancashire is Mired in a Soft Insurance Market

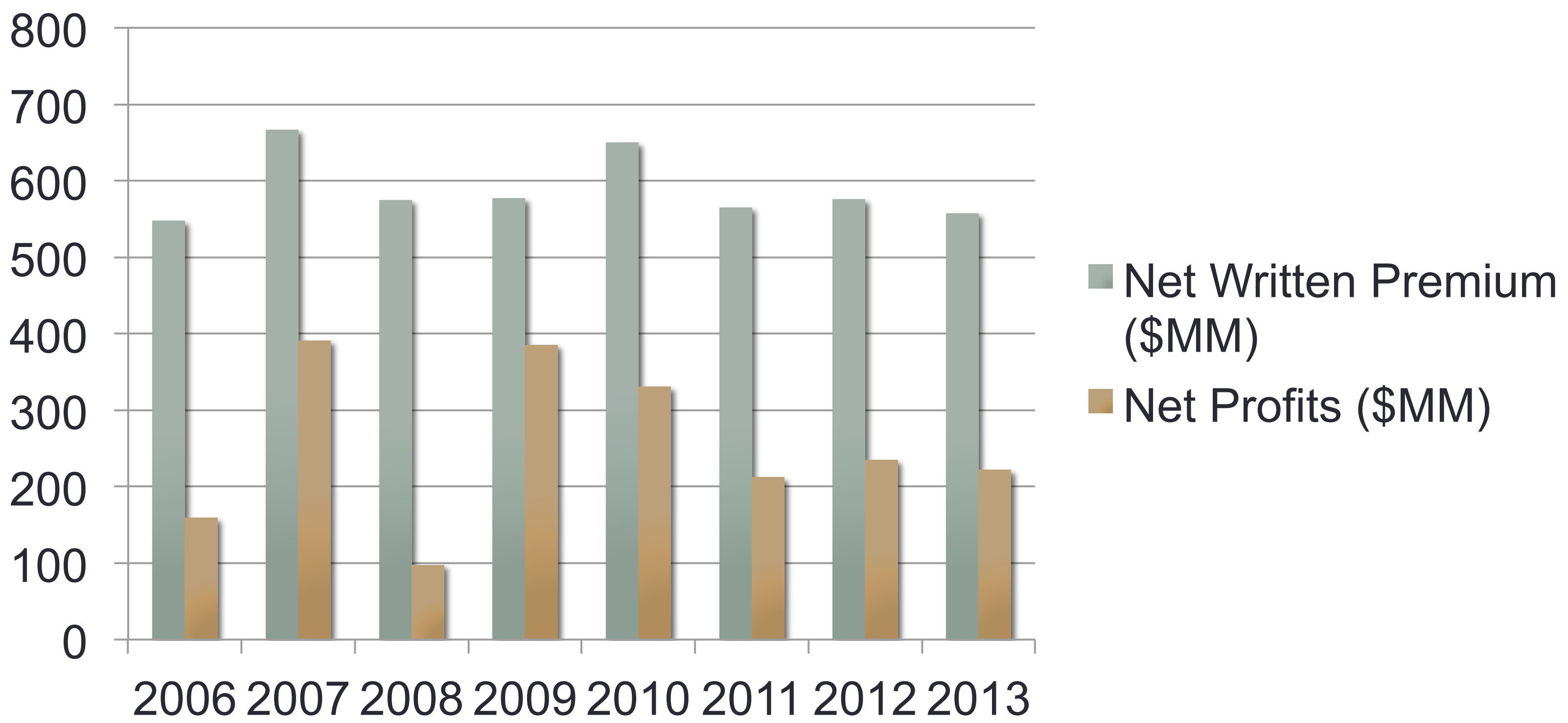
Lancashire Renewal Price Index by Category

	2006	2007	2008	2009	2010	2011	2012	2013
Aviation (AV52)	100	80	69	68	62	59	55	49
GoM Offshore Energy	100	80	64	137	139	140	140	136
WW Offshore Energy	100	80	68	84	88	97	100	97
Marine	100	88	80	82	80	79	86	89
Property Retro	100	97	86	127	121	131	157	152
Terrorism	100	86	71	66	60	57	55	52
Combined	100	86	76	83	81	83	84	81

Source: Lancashire Annual Report

Effects of a Market Awash in Excess Capital

- No growth – premium levels and net income roughly flat for several years
- The market appears to assume that Lancashire will never be able to grow



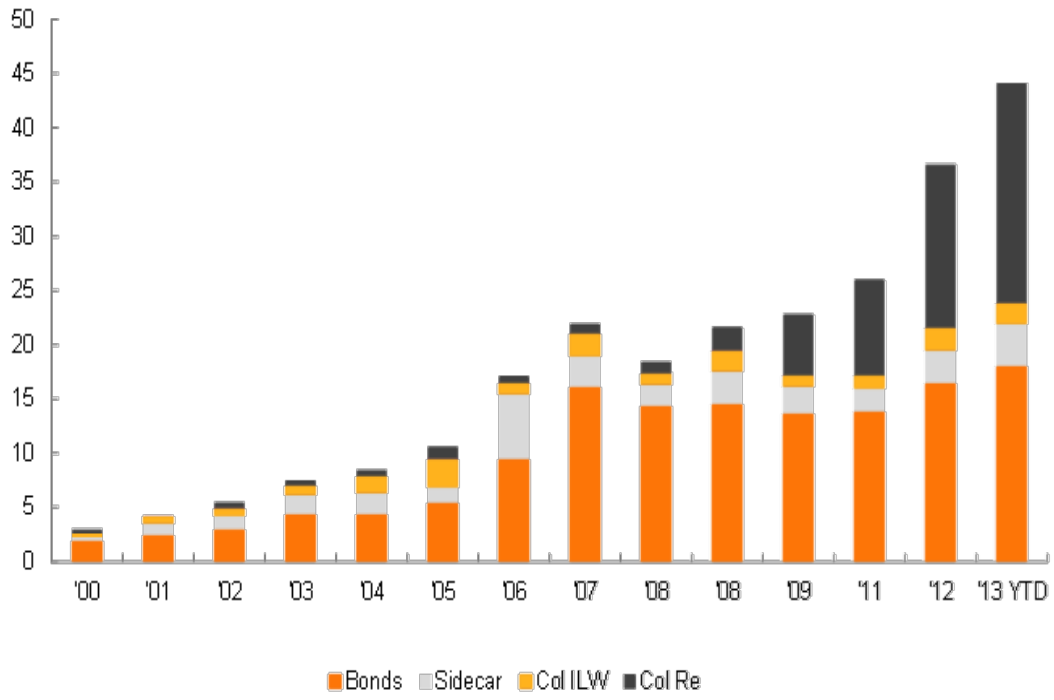
Effects of a Market Awash in Excess Capital

Issue: Lancashire has not been able to reinvest earnings back into the business and earn attractive returns

Response:

- Simple Philosophy – If they can't use extra capital, they give it back
- Stock buybacks when stock was around book value
- Special dividends when stock trades at a large premium to book value
  - Returned to stockholders 92% of all net income over the last 5 years
  - Average dividend yield over the last 5 years has been over 10%

Third Party Capital Invades the Reinsurance Space



Total Alternatives	$44 billion
Collateralized Reinsurance	$20 billion
Collateralized ILW	$2 billion
Sidecars	$4 billion
Bonds	$18 billion

Source: Aon Benfield Analytics and Lancashire

Third Party Capital Invades the Reinsurance Space

- Weak reinsurance pricing cuts both ways for Lancashire
  - Lancashire is both a primary insurer and a reinsurer
    - 60% primary insurance
    - 40% reinsurance
  - Lancashire is both a buyer and a seller of reinsurance
- Lancashire’s reinsurance business is hurt less than most
  - Lancashire is the lead on most business
    - Harder to displace
  - Niche lines of business are less commodity like
- As much an opportunity as a problem
  - Third-party capital needs a sponsor
  - Kinesis – new third party capital management unit

Sources of Upside

Kinesis Capital Management

- Subsidiary recently formed to manage third party capital
- Began 1/1/14, already has deployed $300 million in capital and is likely to continue to grow rapidly
- Kinesis will receive fees, and profit commission
- Lancashire also has a 10% equity interest in reinsurance vehicle and will receive a share of profits
- Most earnings won't be recognized until 2015 – market isn't giving Lancashire any credit
- Capital light as most earnings come from fees and profit commissions rather than company capital – means even higher future ROEs

Sources of Upside

Cathedral acquisition

- First acquisition since founding
- Cathedral had private equity owner, may have been capital constrained
- Underutilized Lloyd’s syndicate
  - Recently received approval to expand size
  - Hired additional experience underwriters

Sources of Upside

Higher Interest Rates

- Higher interest rates mean higher earnings
- Each 100 basis points of higher short term interest rates will increase earnings more than 10%

Sources of Upside

A Hard Insurance Market

- The insurance industry is highly cyclical and at some point the cycle will turn
  - A large natural catastrophe would absorb excess industry capital
  - Higher interest rates may reduce third party capital in reinsurance
- Timing uncertain but a hard market is very likely at some point
- A harder market would allow Lancashire to raise prices on existing business and write additional business on profitable terms
- A very conservative balance sheet would allow Lancashire to respond quickly
- In the last hard market, my other favorite insurance company (HCC) tripled premiums over a 5 year period

Valuation

- Lancashire trades at a big premium to book value – 1.4X
- Lancashire has exceptionally high ROE's – focus on earnings power, not price to book
- Buffett's view (talking about Wells Fargo)
  - Q: How do you view tangible common equity
  - A: "What I pay attention to is earnings power. Coca-Cola has no tangible common equity. But they've got huge earnings power . . .You don't make money on tangible common equity
  - Q: So what is your metric for valuing a bank?
  - A: It's earnings on assets, as long as they're being achieved in a conservative way

Valuation

2013 Earnings		$220 million
Pro Forma 2014 Earnings:		
Add:	Full year contribution from Cathedral	$27 million
	Acquisition expenses	$12 million
	Amortization of intangibles	$13 million
Subtract:	Income from third-party capital vehicles being phased out	$10 million
2014 Pro Forma Earnings		262 million
Fully Diluted Shares		202 million
Pro forma 2014 EPS		$1.30
Current Stock Price (649 pence)		$11.00
Forward Multiple		8.5X

Valuation

Pro forma 2014 EPS	$1.30
Potential Upside:	
Kenisis (assuming $500MM of limit)	$0.20
Cathedral build out adds 10% to revs	$0.10
200 bps increase in interest rates	$0.25
Hard insurance market	???
Potential EPS	$1.85+

Valuation

Potential EPS	$1.85+	
Stock at current 9.4X multiple	$17.39	58% upside
Stock at 11X multiple (3 year average)	$20.35	85% upside
Stock at 12X (higher multiple to reflect growth)	$22.20	102% upside

Risk

- Biggest risk -- founder and long-time CEO retired in April
  - Hidden problems?
  - Change in strategy?
- Integration of Cathedral acquisition
- Big nat cat exposure
- Pressure on rates could intensify
- Can Lancashire manage changes in reinsurance space?

Conclusion

- Lancashire is a high quality company
  - Consistently profitable underwriting
  - Conservative balance sheet
  - High ROE's
- 11% earnings yield
- Lots of earnings upside
- Heads you make a little money, tails you make a lot scenario.
  - If upside never happens, Lancashire will continue to be highly profitable and pay out most of earnings as special dividends (8-10% dividend yield)
  - A hard insurance market is highly likely at some point -- will allow Lancashire to reinvest earnings and compound them at high rates