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## **Small cap insurer Universal Insurance (UVE) plays a high stakes game in Florida**

by **Tarn P Crowe**

Universal Insurance's website (at [universalproperty.com](http://universalproperty.com)) gives the appearance that this Florida insurer possesses sound financial strength. A red elephant stands proudly next to the company's logo and the financial stability rating of "A Exceptional" appears further down the home page.

However, dig a little deeper and you may conclude that Universal's financial condition is not as rosy as it appears.

Universal's questionable rating

Firstly, the "A" rating does not come from a nationally recognized rating service such as S& P or Moodys but from a lesser known rating service used by smaller insurers known as Demotech.

Demotech's definition of this rating follows:-

A - Exceptional financial stability

Regardless of the severity of a general economic downturn or a deterioration in the insurance cycle, insurers earning a Financial Stability Rating® of "A" possess exceptional financial stability related to withstanding a general economic downturn or deterioration of an underwriting cycle.

I believe this rating is misleading and in this article I will detail my reasons for this.

Insurers can minimize their underwriting risk by writing policies in different States, giving them geographic diversity, and by writing multiple product lines they lower their product risk exposure.

Universal Insurance carries greater risk because it is a one state and one product company. Operating in Florida through its subsidiary Universal Property and Casualty Insurance Company(UPCIC) it principally writes homeowners insurance which represents 85% of its premiums and a further 15% of premiums come from dwelling insurance.

Being based in Florida means UPCIC is exposed to substantial catastrophe risk from hurricanes. Further, because it is 100% exposed to property, its losses from hurricane damage will have a greater affect on its financial position than on other more diversified insurers operating in Florida.

Universal expands business rapidly by taking big risks

In the wake of the dislocation in the Florida insurance market after the strong hurricane season in 2005 that resulted in larger insurers reducing their policy coverage in Florida, UPCIC took the opportunity to grow its policy count and expand its premiums rapidly and as of June 2007 had captured a 3% share of the homeowners insurance market in Florida , with around 341,000 policies.

This rapid business growth is reflected in Universal's financial results. Based on the September 2007 quarter, year over year comparison, Universal's earnings growth is 237% and revenue growth 136%. Meanwhile it had an impressive return on equity of 131% and combined ratio in the 70s. Universal's premiums written have grown from \$41 mil in 2004 to \$371 mil in 2006 and are \$263 mil for the first half of 2007.

Shareholders equity has expanded almost three-fold from \$22 million at December 2006 to \$63 million at September 2007.

Yet all this has been achieved by Universal taking on enormous risk, a strategy of win big or lose massively.

At the Small cap equity conference in August 2007, Bradley Meier ,CEO of Universal ,detailed Universal's exposure to a major hurricane or catastrophe. He said that based on their models, Universal would take a \$45 million dollar hit on the first storm, \$9 million on the second event and \$9 million on a third event. Translated, if the hurricane events of 2004 or 2005 repeated themselves in 2007, Universal would have been exposed to \$63 million in losses before tax, over \$40 million after tax. That would have taken a 67% chunk out of shareholders equity of just \$63 million.

Universal relies on models due to its short operating history

Furthermore, these forecasts given by Meier are based on models and assume reinsurance coverage. Universal's models are based on industry data rather than individual data, because Universal is a relatively new insurer. If problems emerge that Universal's models are not correct or a reinsurer is not prepared to foot the bill, Universal would have very little shareholder's equity to play with. There is simply little or no margin of error.

A substantial hit to shareholders equity would threaten Universal's risk based capital position under the Florida insurance Code and could force Universal into a substantial dilutive share offering to protect its capital position. It may in turn be required to reduce its premium levels to reflect its revised capital position.

Fortunately for Universal insurance , both 2006 and 2007 were benign years for hurricanes. However, there are no guarantees for 2008. Universal has indicated it is preparing to apply to other States to expand its geographic reach, one would suggest this should be a priority.

A further look at Universal's reserve for unpaid losses and LAE estimates may give investors some more cause for concern. As at 31st December 2006, LAE estimates given by Universal's actuaries were between \$37 million to \$60 million. Universal booked its

actual reserves at \$49 million. As well as the fact it is relying on industry data (due to its short claims history) , Universal's reserves don't provide much scope for error. If Universal had used the higher actuarial estimate of \$60 million, this would have reduced its shareholder equity by 50% from \$22 million to \$11 million as at December 30, 2006.

Universal's share price doesn't account for risks

Universal's share price takes no account of the high levels of catastrophe risk faced by its operations. It sports a market cap of around \$280 million or 4.4x its book value of \$63 million. This is well above its peer average of 1.7x.

Insiders have cashed in on the high share price selling 3.1 million shares over the last 6 months according to yahoo finance. There have been no insider buys during this time.

Concluding remarks

Universal has succeeded in growing rapidly in Florida however it has only achieved this by effectively "betting the house". This Company does not deserve an A rating and its high share price masks the high level of catastrophe exposure its business faces.