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VALUE CREATION

Following our recent visit to Toronto for the Fairfax Financial Holdings annual shareholder meeting and its surrounding events, we once again left confident in the firm's leadership, as well as the firm's relatively unpublicized value that it delivers to its shareholders. In addition to the shareholder meeting, surrounding events including the Ben Graham Centre's Value Investing Conference hosted by the Ivey Business School are first-rate in quality, featuring talks and panels with seasoned and accomplished, value investors. During this year's gatherings, we had the great fortune to visit with private equity investor Wilbur Ross of W.L. Ross, as well as hear his key note address during lunch at the Value Investing Conference. In our view, Mr. Ross's talk highlighted a critical but generally overlooked variable to the Fairfax investment thesis.

For those who are less familiar with Fairfax , perhaps the association that first comes to mind is Blackberry. This is somewhat understandable, albeit superficial, given its high profile coverage within the financial media over the past twelve months or so. Fairfax is the largest shareholder in Blackberry, and over the course of late 2013 was conducting due diligence following its bid to purchase the remainder of its shares and take the company private offered in September 2013. Later in November the transaction was cancelled in favor of a $1 billion capital injection through 6% debentures convertible at $10 per share. So while Blackberry stole the headlines and remains front of mind for many, we have remained fixated instead on Fairfax's largest share position. This same investment also happened to be the topic of discussion for Wilbur Ross's keynote address to a room full of attentive value investors in Toronto. Within the discussion that follows, we will relay in a much condensed version, the details of an investment that Fairfax and W.L. Ross spearheaded (with Fidelity and Capital Research following passively) into the Bank of Ireland during the thick of the European debt crisis in 2011. Before we begin however, we are reminded of a quote from the famed trader of the 1920s and 1930s, Jesse Livermore (paraphrasing from his book How to Trade in Stocks) to provide context.

Over a long period of years I have rarely attended a dinner party including strangers that someone did not sit down beside me and after the usual pleasantries inquire:

"How can I make some money in the market?"

It is difficult to exercise patience with such people. In the first place, the inquiry is not a compliment to the man who has made a scientific study of investment and speculation. It would be as fair for the layman to ask an attorney or a surgeon:

"How can I make some quick money in law or surgery?"

If we allow the gaze of our mind's eye to return to the financial markets of mid-2011, what we see is a broad and unwavering pessimism surrounding the fate of the European economy and its commonly held currency. Greece was one year removed from its first bailout, and the revelation that its budget deficit was 13.6% of GDP (not the 3.7% it had reported for 2009) jilted the markets. Ireland's bailout had come in November of 2010 and by mid-2011 Portugal had joined the club. European stocks were in a free-fall, declining from 20-30% depending on the index from February through September of 2011. European bank stocks fared even worse. By July 25, 2011 the date of the announced EUR 1.123 billion investment into the Bank of Ireland (BOI) by a Fairfax led consortium, BOI's stock had collapsed 95.3% from its

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September 2009 high. Clearly, to the casual observer, and to most professional investors too, the Bank of Ireland's quandaries were both onerously complex and severe. Part and parcel to the complexity of the situation was that Ireland is a small country of 4.6 million people, and with Bank of Ireland as its largest bank and a substantial holder of Ireland's sovereign debt, their two fates were inextricably linked. Therefore, a successful rescue of the Bank of Ireland was the essential piece towards rescuing Ireland itself from its economic prison. So, while there was a profit motive it is also easy to see the courageous rescue attempt of BOI as being simultaneously aligned with Ireland's own recovery from an economic abyss.

An economic abyss, it was indeed. As Wilbur Ross recalled during his comments, at the time, Ireland faced 14.5% unemployment, shrinking GDP, rising mortgage delinquencies, falling real estate prices, and finally bank loans were 9x Ireland's GDP, which was a ratio 10x greater than the same loan to GDP relationship in the U.S. However, and as Mr. Ross described, it was a benefit that the situation was both dire and complex because this meant that there were fewer competing investors offering bids (which implied the Fairfax party could obtain an attractive price…buying at the point of maximum pessimism), and the other bidders that did emerge wanted too many assurances attached to their terms. Given the scope of the challenges that the bank and the sovereign faced, the ultimate success of the turnaround transaction begs examination from serious investors. Perhaps not surprisingly, the Bank of Ireland rescue has since become a case study at the Yale School of Management.

In light of the challenges, and the fact that they were successfully met, one might guess that this transaction offers a treasure trove of investment lessons for the value investor. In the following discussion we will delineate the transaction within the framework of the significant lessons gathered from these investment legends.

Many investors of the bargain hunting disposition will recognize the first lesson that Mr. Ross imparted, which is "you can get paid generously for perceived risk, but you don't necessarily get paid for taking real risk." The task of course is to examine the facts and decide to what degree investor perception is matched with reality. The chore here tilts towards a psychological burden—in our opinion—to force an objective analysis of the longer-term picture and determine its attractiveness. In this case, the consortium had the benefit of years of analysis and familiarity with the Irish economy since Fairfax possesses reinsurance operations in the country. In sum, despite its dark near-term image in 2011, Ireland was and remains in our opinion to be an attractive investment environment. Note the fundamental facts (cited by Wilbur Ross): By far the lowest tax rates in Europe with corp. rates at 12.5% and a 25% R&D credit, a young and well-educated workforce, sovereign debt at 25% of GDP, a fully funded national pension plan, favorable trade balances, good transportation and infrastructure, a high tech economy dominated by pharmaceuticals and tech firms, and ostensibly the only English speaking country that uses the Euro. As a signpost of its macro attractiveness, U.S. corporations have invested $160 billion into this country of just over 4 million people, which represents more investment dollars by U.S. companies into Ireland than all of the BRIC nations combined. In conclusion, Wilbur Ross remarked that the macro picture was essential to committing funds in that "you cannot micro-manage your way out of macro problems." The fact that the Irish government had quickly slashed its budget, and that its citizens were not rioting, but rather accepting the challenge of mending itself, spoke measures to the Fairfax consortium. Another interesting layer to the front-end of the transaction was that Prem Watsa (Chairman and CEO of Fairfax) and Wilbur Ross believed that their investment into the bank would begin to re-shape investor perception. This calculation proved correct, as following the announcement of the Fairfax deal, Deutsche Bank restored credit lines and windows with the Bank of Ireland a few weeks later.

The second investment lesson shared through this transaction is directly relevant to turnaround and/or distressed investments, and not necessarily applicable to all other variations of value investing. In Mr. Ross's words, "Implementation is the sine qua non" and that he would rather back a "mediocre idea that is brilliantly executed versus a brilliant idea with mediocre execution." In this lesson, we can see what truly separates investors such as Prem Watsa or Wilbur Ross from legions of others, which is to synthesize the earlier lessons of conducting objective analysis and then possessing the courage of one's convictions to invest (passive investing) with an ability to *create* value (through active investing) where it did not exist before. Namely, following the initial challenges to investment, the investors must then restructure and turnaround the business in order to extract its intrinsic value (and generate a return). At the outset, the Fairfax and W.L. Ross teams had generated an exhaustive, if not ambitious set of goals for BOI. Armed with two board seats and a management team, as well as an Irish government that backed their efforts, Prem Watsa and Wilbur Ross set out to turnaround the beleaguered bank. For perspective, consider the list itself, and the fact that their teams successfully executed on each item: Push for an immediate increase in loan loss reserves, as much as a model would allow to protect against future losses; avoid foreclosures in lieu of restructurings for borrowers who wanted to pay but were pressured by the recession; renegotiate the bank's pension obligations, which according to Irish law required individual signatures from the pensioners themselves (it was facing a 1 billion EUR deficit); implement 2,500 redundancies; modify "tracker" mortgage contracts tied to indexes that made them unprofitable; eliminate all government guarantees on deposits (was costing BOI EUR 380 million per year); disassemble and repay the EUR 5 billion in capital supplied to BOI by the Irish government through numerous securities including convertibles; resolve the geographic mismatch between the bank's assets and liabilities that led to enormous currency hedging expenses; become first Irish bank to offer mobile banking; reduce the loan to deposit ratio from 170% to 115%; convince the EU to not force the sale of BOI's highly profitable life insurance subsidiary; avoid any further equity issuances at a price below book value; and then finally, throughout this, somehow maintain organizational morale. The fact that Fairfax and W.L. Ross maintained morale by negotiating these potential conflicts through mutually agreeable terms was not only impressive, but essential to the transaction's success.

A third lesson emphasized by Wilbur Ross is the thoroughly quixotic, yet all too practical element of getting the timing at least somewhat right on these situations. Mr. Ross pointed out that had they made their investment in the first rights offering for BOI at EUR 0.55 per share, versus the second at EUR 0.10 per share, that their investment would still show a loss today. Instead, BOI showed a return of approximately 289% at the stock's recent high in February 2014, which represents a heavily rewarding windfall to shareholders in Fairfax Returning to the matter of timing however, Wilbur Ross stressed that in turnaround scenarios it is better in his experience to pay slightly more and not be too early, citing that the additional data points are valuable. In sum, he mentioned that he maintains two plaques in his office, with one stating, "Duration is the Natural Enemy of Return" and the second that "Time Equals Risk." On the issue of timing as a component of return though we hasten to mention that Fairfax and W.L Ross were careful to quantify a margin of safety on the front end. More specifically, they understood that there were pieces of the BOI enterprise that could help drive a valuation that was a premium to book value once the elements of distress and uncertainty lifted. These pieces included a vast distribution network of bank branches located in U.K. Post Offices which was an exceedingly low overhead network matched with banking activity, as well as a mid-cap leveraged buyout business in Europe and the U.S., and as we referenced earlier it possessed the number two life insurance business in Ireland. This bottom-up analysis proved pivotal as Wilbur Ross related that shortly after the deal commenced, the stock fell another 20%, which prompted them to buy additional shares. For perspective, Mr. Ross believes that based on their analysis the transaction was consummated at 35% of pro forma book value, a level that he quipped "would make Ben Graham's eyes tear up."

During Wilbur Ross's remarks to the Value Investing Conference he commented on a reality that we have understood for several years as active buyers of Fairfax shares when they were priced at or below their book value due to the market crisis du jour. Mr. Ross laughed that of the investor consortium, W.L. Ross and Fairfax were suckers for having to do all the work while Fidelity and Capital Research only had to bring their money (investing passively). This statement applies equally to Fairfax shareholders who participated in this transaction through their ownership of Fairfax shares. To be sure, you might consider the simple question as to what level of fees W.L. Ross & Co. charges its private equity clients (and in a sense the fees paid for access to this transaction). Admittedly, that may not be an apples-to-apples comparison, but given the track record behind Fairfax, and its penchant to create value over long periods of time both on its own and through the pooling of expertise (i.e., Bank of Ireland transaction), it is certainly not an irrelevant point. The point is that our constant goal of generating sustainable wealth for our clients relies upon thoughtful investment in the managers of assets who in turn aim to create value on behalf of their shareholders.

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