

THE BIG SECRET ON WALL STREET

The Insurer That Treads Where Others Fear

- *An Unusual Company With a Very Special Focus*
 - *An Outperforming and Underappreciated Niche in the Market*
-

FROM THE DESK OF PORTER STANSBERRY

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Firefighters conduct a controlled burn to defend houses against flames from the Ranch Fire, part of the Mendocino Complex Fire, as it spread towards the town of Upper Lake, California on August 2, 2018.
Credit: Mark Ralston/AFP via Getty Images

Soft-spoken Tania Volhonseff – an 81-year-old retired teacher living in Windsor, California – has already lost one home to wildfires.

"I opened the front door, and I saw the vinyl siding on my house rolling off

from heat. And I thought, you know what? This is not a good time to be in here," she said.

That turned out to be an understatement.

"As I was stepping out the door, I could hear windows cracking. And within seconds, the house was filled with black smoke."

Tania's house burned to the ground and had to be completely rebuilt. In the meantime, she had to evacuate her temporary housing due to yet another fire.

"I did not envision this sort of life, where the last three years I have been dealing with insurance companies," she said.

All told, Tania has had to leave her home in a hurry four times since 2017 due to California's raging wildfires. She keeps a "go bag" packed with her important documents. And yet – speaking to NPR with wistful optimism – she doesn't see herself moving away anytime soon.

"Well, the home that I had, we remodeled about 10 years ago. And it's a lovely – it was a lovely home. And I hope that, well, I'm going to have a lovely home again. I would like to stay in my home. The only thing that crosses my mind is, what's to prevent another fire to go through there, you know? But we have so many fires in California now. I think I'll wait for a while and see how things go."

Tania's nightmare experience is echoed across the smoldering state of California, where last year alone, 7,490 wildfires destroyed 362,455 acres – more than one-third the size of Rhode Island – and killed nine people. Since 1950, the area decimated by California's summer burns has steadily increased, with eight of the ten largest wildfires occurring since 2017. (One study estimates that California's 2018 wildfire season alone caused \$148.5 billion in damage.)

It's gotten so bad that insurance giants Allstate and State Farm don't even want to be there.

Early in June 2023, the two companies – the fourth-largest and largest insurers in California, respectively – made national headlines when they announced they'd no longer be offering property and casualty insurance in California. (They follow the example of AIG, which quietly dropped thousands of California customers the year before.)

As Allstate put it,

"The cost to insure new home customers in California is far higher than the price they would pay for policies due to wildfires, higher costs for repairing homes, and higher reinsurance premiums." State Farm was blunt: "(It's) necessary to take these actions now to improve the company's financial strength."

In other words, if you want insurance in California right now, Allstate and co. are not your friend.

Of course, there's always the "FAIR" plan, an "insurance pool" created by California state legislators. It serves as a temporary, and expensive, safety net for Californians who can't find property and casualty coverage – and offers minimal coverage at nosebleed rates. Still, FAIR plan enrollment is up 70% since 2019.

Or, you can take your business to a smaller "specialty" or "excess and surplus" (E&S) insurance company.

E&S companies focus on markets that require deep knowledge of specialized niches of the economy, like medical malpractice, skydiving, restaurants, and many other arenas, where risks are not standard and straightforward.

This is a business that does things that mainstream insurance companies won't do. It goes places they won't go. And E&S companies are more than happy to step into the empty, wildfire-charred space left by frantically retreating mainstream insurers.

In the words of the company we'll be looking at in this report:

"Our Transactional E&S underwriting division provides primary and excess non-catastrophe prone property and general liability solutions, with particular emphasis on risks that are considered hard to place because of the complexity of the underlying exposure, loss history, and/or limited operating history (i.e., start up and newer businesses)."

Some of the insurers in this niche are extremely successful – as reflected in the outperformance of their shares.

The company we're about to explore today, we believe, is one of those.

What Is Skyward Insurance?

Skyward Specialty Insurance Group Inc. (NASDAQ: SKWD) is a property and casualty ("P&C") insurance company that sells insurance to commercial clients (rather than to individuals). The U.S. property and casualty industry is a \$722 billion premium industry, with about half of that sold to commercial lines and half sold to individuals.

Skyward is growing fast, and is a relatively small – and new – player in the commercial P&C industry, with 2022 full-year premium of just over \$1 billion. The company went public in January 2023 at \$15 per share, raising about \$135 million in equity. The company's headquarters are in Houston, Texas.

Skyward focuses on “excess and surplus” (E&S) and “specialty” insurance that includes crop, livestock, and other renewable resources; property coverage for large multi-jurisdictional entities with complex property exposures; and also high-risk industries like construction and energy. (We'll dig more into the differences between E&S and specialty insurance in a moment.) Because of its E&S focus, Skyward competes less with the standard commercial lines insurers (like Hartford and Travelers), but more so with other specialty insurers (like Markel, W.R. Berkley, and RLI).

Here's a quick look at the company's recent financials:

- Total premiums of \$1.14 billion in 2022, up ~31% from 2021's \$868 million.
- A combined ratio of ~93% in 2022 (indicating an underwriting profit margin of ~7%).
- An ROE in the low teens (one of the best in the industry).
- A strong balance sheet, with cash and invested assets of \$1.17 billion at year-end 2022 (up 14% from 2021).

In this report, we'll discuss a number of reasons why we think SKWD shares are poised to appreciate.

But before we dive in, let's take a closer look at the E&S and specialty insurance market – and why the market environment is positive for these types of stocks right now.

E&S vs. Specialty Insurance: What's the Difference?

We can break up the property and casualty industry based on the *complexity of the risks being insured*.

At one extreme are the fairly straightforward risks that, by definition, require little attention from individual underwriters to understand their risk characteristics and appropriate pricing. Here you'll find, for example, most automobile and homeowners' insurance. You'll also find insurance for most commercial properties and buildings. This “traditional” insurance is offered by some of the larger insurance companies (Allstate, Travelers, AIG, etc.).

This traditional insurance is also often called “**admitted**” insurance. “Admitted” refers to insurance that is offered by companies that are recognized, licensed, and regulated by individual state insurance regulators. This means that insurers conform to regulations relating to policy forms (contract language) and rates

(ensuring that insurance rates are fair, adequate, and not discriminatory). Regulators also ensure that insurers maintain solvency, so that they can pay claims when they occur. Note that stocks in this category typically trade around 1.1x-1.3x book value (more on book value below); a “standard valuation” for writing “standard risks” – and resultant levels of profitability.

At the other extreme is the “**non-admitted**” – or E&S – lines insurance market, which focuses on risks that are not standard, but are rather much more complex in nature and require specialized underwriting skills. This insurance is sold by “non-admitted” insurers, which means they are not licensed or regulated by state regulators. Not regulated also means that insurers are free to charge whatever rate they can get in the market; risks in this market cannot find insurance coverage in the standard market, and thus need to pay the higher prices that come with being in the E&S market.

Examples of risks that might be included in the E&S market include coverage for a boat on the Hudson River setting off fireworks on the 4th of July, or homes and buildings in high-risk areas (the Gulf Coast of Florida or areas prone to earthquakes or wildfires). Also here would be casualty coverage for companies with a history of significant losses, or new ventures with little history. Stocks in this category can trade for as high as 10x book value, due to the higher margins of the type of business.

In between these two extremes is what is known as “**specialty**” risks. This business isn’t quite as run-of-the-mill as the standard/admitted market, but also not as specialized/risky as the E&S market. Examples could include insurance for bars that serve alcohol, or certain classes of construction (roofers, for example). This insurance is offered by both the standard insurers as well as those that specialize in the E&S market. Stocks in this category typically trade north of the standard valuation (1.1x-1.3x book value, but below the pure play valuations that can be as high as 10x book value).

The overall market is referred to as “E&S,” though many companies (like SKWD) offer both E&S insurance and “specialty” insurance as a subtype. SKWD’s overall business is split about 50/50 between specialty and E&S.

E&S is a relatively small market right now – but it’s en route to much bigger things.

Why the E&S Business Is Set to Expand

The E&S insurance market is tracked separately from the standard insurance market (and is not included in the overall industry premium figure). With annual premium for the E&S market of around \$85 billion, it’s significantly smaller.

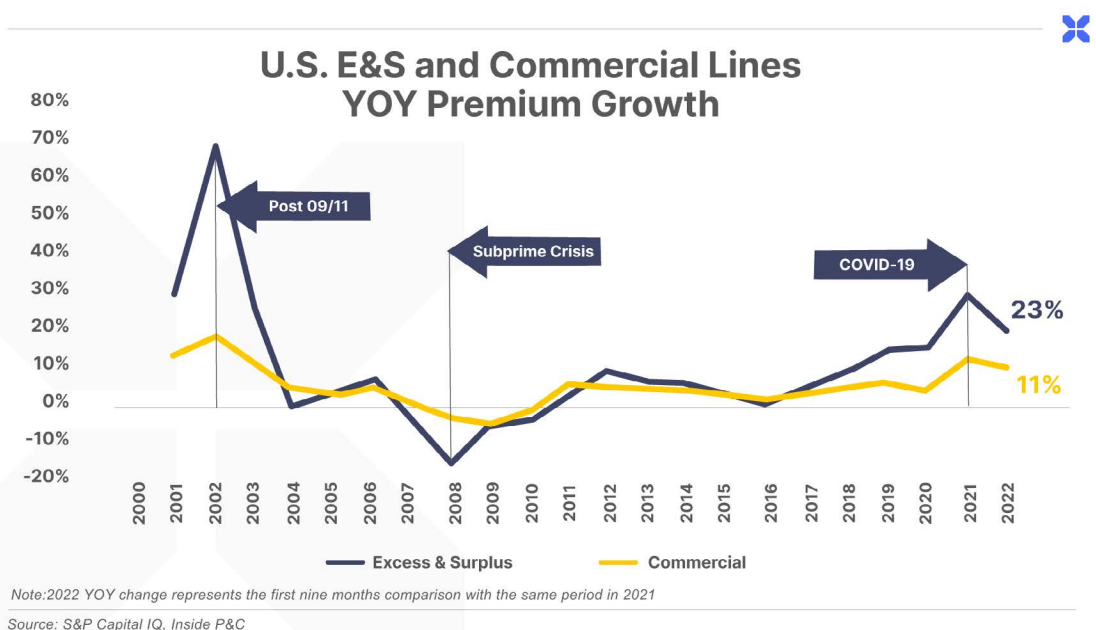
But it’s growing faster and has better margins than the standard insurance industry. The E&S market is expected to grow by double digits for the next few

years, according to most market observers. At the same time, the combined ratio (the measure of underwriting profitability) is expected to be at least 7 points better than the overall average P&C combined ratio of 99%.

One of the key drivers of growth in the specialty and E&S markets has been the decline in the risk appetite of admitted U.S. carriers after a few years of catastrophic losses. Natural catastrophes like wildfires and hurricanes, social inflation (which are losses associated with large jury verdicts and increased litigation), and the emergence of cyber threats have dimmed the risk appetite of many traditional carriers, which shy away from these kinds of risks.

That's created an opening for those operating in the E&S insurance market. For instance, State Farm and Allstate's recent exodus from the California market is an example of a massive decrease in the availability of insurance – a gap that will surely be filled by specialty companies like SKWD.

As the chart below shows, premium growth in the E&S market can be much faster than in the traditional/standard commercial market, reflecting not only the higher pricing the E&S market can obtain, but also the influx of accounts into the market as risks can't find an insurance home in the traditional market.



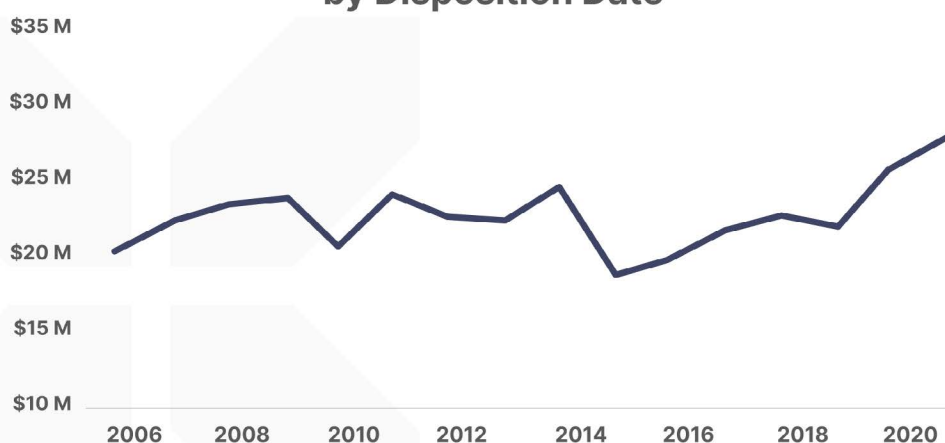
Social inflation is also important for the growth of the E&S market. It describes the increase of insurance claims payouts and loss ratios due to non-economic factors resulting from the high costs of liability litigation. Drivers of social inflation include:

- “Nuclear” jury verdicts (awards of \$10 million or more; see graph below that shows the steady increase since 2014);

- Third-party litigation funding, in which investors supply funding to plaintiffs/attorneys in exchange for a percentage of the resulting litigation;
- Changing societal attitudes regarding liability and responsibility;
- Emerging risks like new diseases (Covid) or harmful substances;
- Increased legal advertising, which prompts people to sue more often.



Median Cost of Verdicts Over \$10 Million by Disposition Date



Source: VGM Insurance — "In the know: Social Inflation and the increasing costs of jury verdicts"

Similar to the surge in social inflation, Directors' and Officers' and employment practices liability lines have experienced a surge in losses resulting from increased litigation costs and skyrocketing jury verdict inflation. As a result, many standard carriers have pulled back from that market, creating an opportunity for E&S carriers like SKWD to step in and fill the void.

Because the E&S market focuses on complex risks that most admitted insurers will no longer write, E&S insurers are able to demand high premiums. E&S carriers have had the opportunity to set the rates and conditions for the coverages that they are extending, and they are seeing plenty of new business coming into the market.

And SKWD is perfectly positioned to take advantage of all that new business.

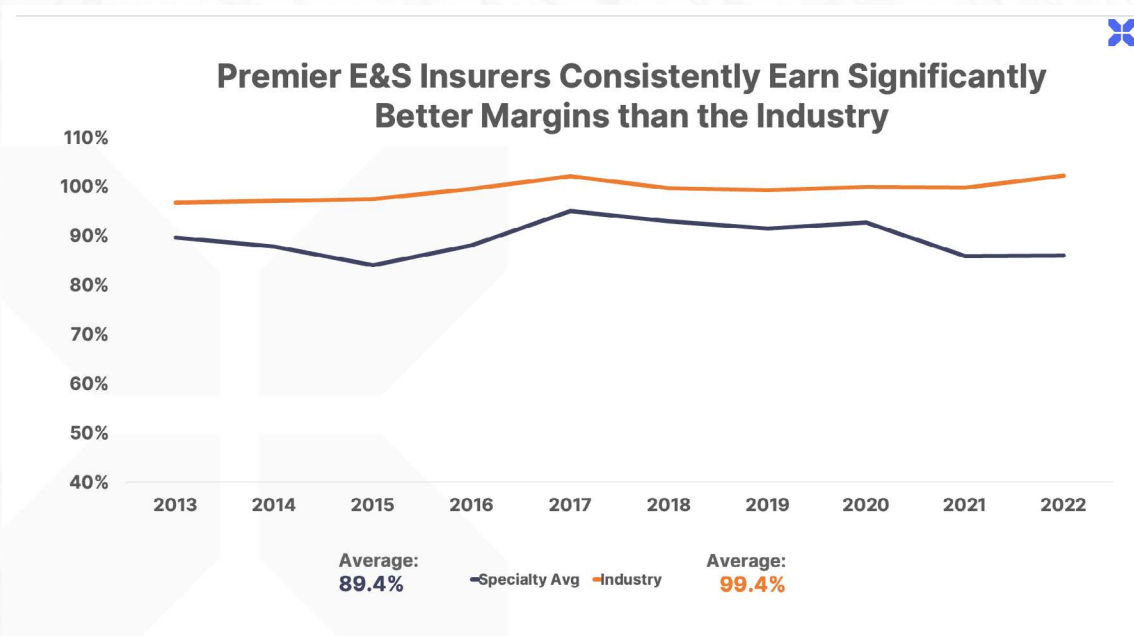
SKWD's Stock Multiple Is Set to Increase

We believe that Skyward's stock price multiple will increase, as the company continues to gain the trust of investors and solidifies its position among other leading E&S insurers – whose multiples are well above not only industry averages, but also SKWD's current multiple.

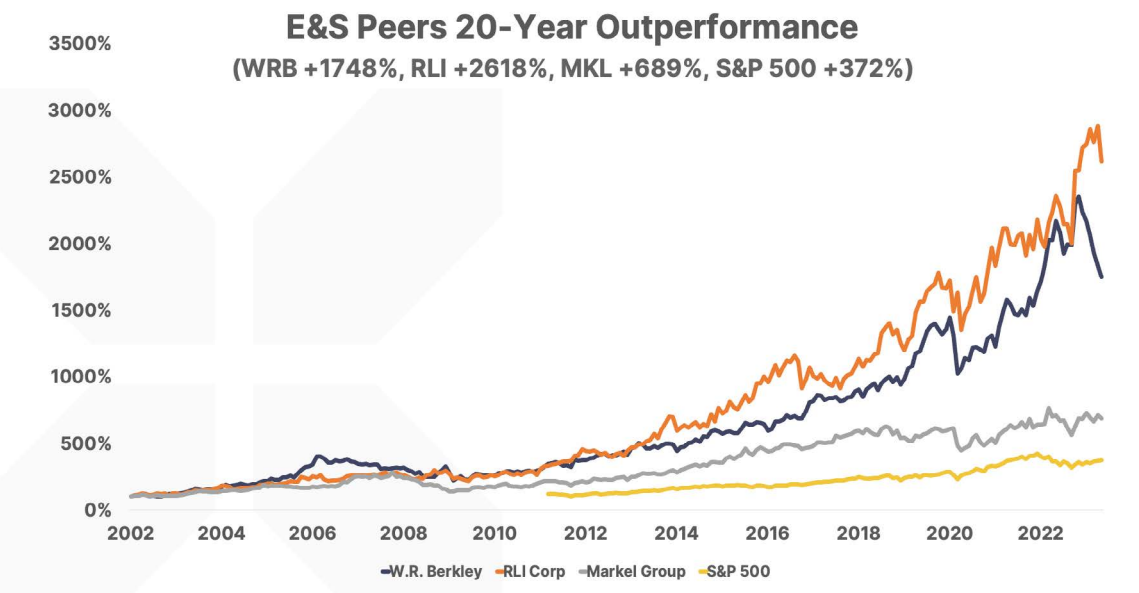
In the P&C industry, there are some companies whose long history of operating outperformance has “earned” them the right to trade at multiples – 2x-3x book value, if not more – much higher than the rest of the industry (that trades at ~1.2x book value). Given the specialty nature of the E&S space, where underwriting expertise in specific niche businesses is a barrier to entry, a few companies stand out in this regard. We detail book value, and how this valuation metric works, here.

Companies known as some of the best in the specialty insurance business include American Financial Group (AFG), Kinsale (KNSL), Markel (MKL), RLI (RLI), and W. R. Berkley (WRB). If we look over the past 10 years, we see the average combined ratio (essentially, insurance-speak for a measure of underwriting profitability; specifically, losses paid divided by premium revenue collected) of these five companies is 89.4%, a full 10 points better than the P&C industry average of 99.4% over the same time period. (For further explanation of the combined ratio, see our Guide to Property & Casualty Insurance.)

The graph below tracks the combined ratio for the industry and for a group of specialty insurers (recall: combined ratio is losses divided by premium, so a low number is better; 100% is “breakeven”).



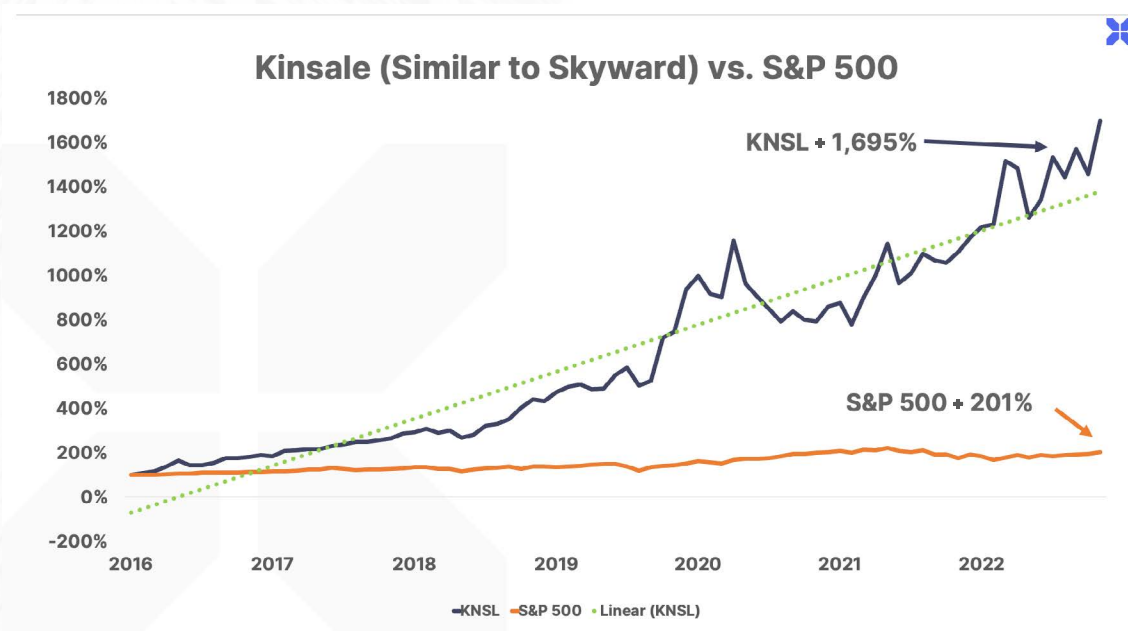
Those consistently better margins should lead to stock outperformance over the long haul, as has been the case for these premier specialty insurers.



Kinsale Capital Group Inc. (KNSL), an E&S company around 30% bigger than SKWD in terms of premiums written, went public in 2016 and may provide a rough template for the potential trajectory of SKWD...

KNSL has outperformed the S&P 500 by almost *10 times* while its valuation has exploded from 1.5 times book value at IPO to just under 10 times book value today. As a pure-play E&S writer (meaning it only writes Excess & Surplus lines business), KNSL's healthy valuation shows just how much value investors are placing on the E&S market now.

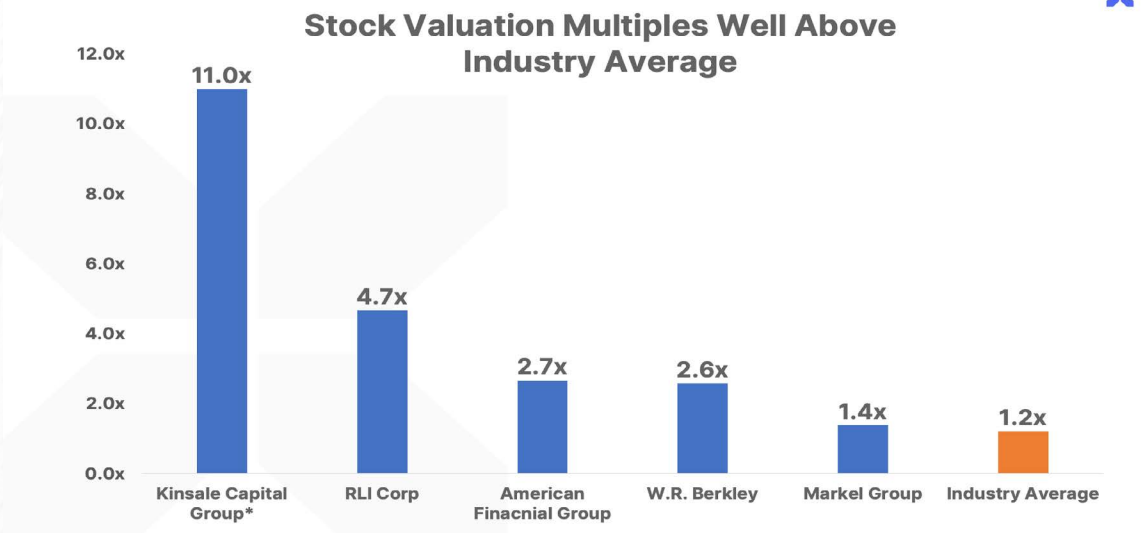
The stock's outperformance is also a reflection of upside potential with proper execution of the fundamentals of the business – disciplined underwriting, operating in niche markets that the company understands well, and taking advantage of changing risk appetites. It also demonstrates how much theoretical upside opportunity *could exist* for SKWD as it delivers on its promises.



We see a range of valuations for commercial insurers, ranging, at one end (a) the traditional standard insurers that typically trade around 1.1x-1.3x P/BV, to (b) pure play E&S carriers (like KNSL) that have traded at valuations 10x book value.

SKWD isn't a traditional standard insurer, but isn't a pure play E&S carrier either. Given its mix of "specialty" business and E&S business, we think its long-term valuation could settle well north of its current level but see a level like KNSL's as a ceiling. Specialty business is less risky and unique than pure play E&S business, so trades less than pure play E&S ... this is where SKWD fits in.

The table below depicts the average price-to-book value (P/BV) ratio for a peer group of companies that write a majority of business in the E&S markets. The average P/BV ratio of all of them is 4.5x. However, even if we exclude the highest (KNSL) P/BV and the lowest (MKL) P/BV, the average is still 2.7x. (We exclude MKL due to the fact that its invested assets are managed differently than most insurers. It has a much higher concentration of risky invested assets (equities, private equity) that has produced a much higher (yet more volatile) growth in book value over time.)



SKWD shares trade at a valuation of only 1.6x book value, implying significant

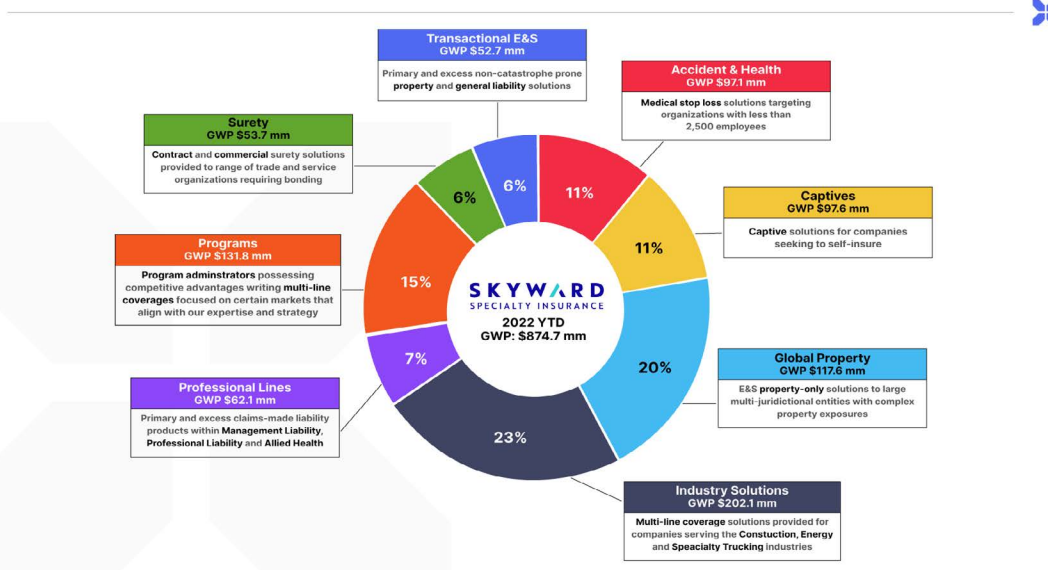
upside in the valuation just to get to the peer group median of 2.7x (excluding MKL and KNSL). If SKWD shares were only averagely valued, the share price would be well over 50% above current levels.

We believe that SKWD could experience some level of the same multiple expansion and outperformance given the current favorable market conditions for the E&S market.

We also see upside based on its diversified product portfolio, conservative investment strategy, and experienced management team, which has already limited potential losses through a Loss Portfolio Transfer contract. Let's dig deeper into these three characteristics...

1: Diversified Product Range

First, SKWD has a highly diversified mix of business that is designed to limit its overall volatility over time. A diversified business profile allows SKWD to respond to, and capitalize on, changes in market conditions across P&C cycles that are not available to those underwriters with a narrower focus. Not only is it a fuel for premium growth, but also allows a management team to be more disciplined in its underwriting. With a highly diversified portfolio, management is able to decelerate its growth in one area of business without risking a heavy decline in market share. A highly diversified product portfolio is analogous to the benefits associated with a diversified investment portfolio ... eliminating concentration risk that can cause harm if one area of the market takes a beating.



For an insurer, diversification can also help because certain areas of the P&C market go through the pricing cycle at different times. Sometimes the professional liability market will be a loss-leading business while accident & health, or commercial property, is thriving. Having a diversified portfolio allows SKWD to react quickly to changing dynamics in the market without hurting profitability.

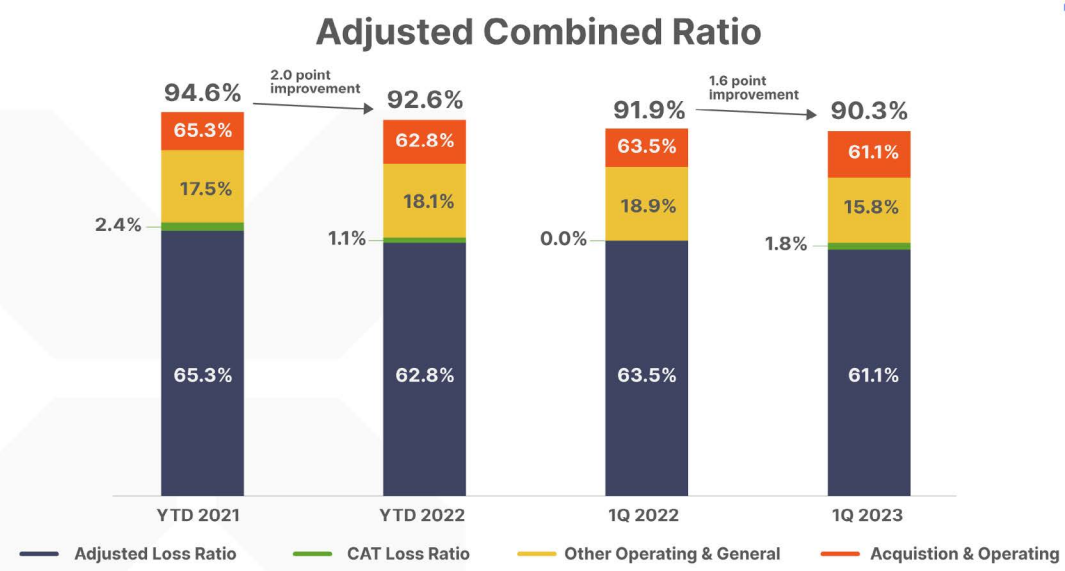
SKWD has built a diversified group of underwriting divisions spanning multiple product lines, industries, geographies and distribution channels. For example, in its medical professional liability business alone (4% of total premium) it writes at least 11 different types of targets, such as dialysis centers, laboratories, nursing schools and virtual health services. The company has adapted to changes in the market, growing certain lines of business when market conditions are favorable – and limiting its exposure to certain markets when conditions are less favorable.

Skyward's strategy rests on having scale – that is, being large enough in certain specific areas that efficiency gains are made – in very narrowly defined and diversified niches, and giving managers of those niches the authority to run their businesses as they see fit. It calls this strategy – appropriately enough – “Rule our niche.”

Because the E&S industry is poised to experience even more improvement in the fundamentals, we believe that will bode well for SKWD's underwriting profitability improvement as well.

The combined ratio on its ongoing, core business (the adjusted combined ratio, as depicted in the graph below), which excludes any potential losses associated with

its exited business, is evident in the chart below. Note how their results have improved from a 94.6% (2021) to a 90.3% (1Q23).



Because many standard P&C carriers have begun pulling away from certain markets, many of the niche markets – like professional liability for lawyers and architects, and niches within the transportation sector like trucking fleets – have become underserved. This leaves an opening for SKWD – which focuses its efforts on getting to know and understand complex, hard-to-place risks like these, and such as commercial properties with unique or special features, such as historical buildings or properties with high-valued assets.

Having more leeway to come up with solutions to non-traditional risks means SKWD is better able to build creative solutions for their clients...

As we mentioned earlier, cyber risks are increasingly being shunned by the standard market, and this creates opportunities for the E&S market. To take advantage, SKWD recently announced a partnership with Cowbell, a leading provider of cyber insurance for small and medium sized enterprises. This is a strategically smart way to enter into new markets – by leveraging the expertise of Cowbell – and bring new offerings to underserved markets that are growing rapidly.

The legal cannabis industry is another example of a sector that is very much reliant on E&S capacity to transfer risks like product liability, transportation, property, and general liability, as the industry has a wide variety of exposures and requires a very specific kind of underwriting. SKWD entered that market in 2021, taking advantage of dislocations in niche areas of the market. In order to learn the insurance needs of the industry, it first partnered with a company more familiar with the cannabis industry. Then, within six months, it launched its own insurance products, including

professional and executive liability insurance (to protect owners/operators of cannabis stores from liability) as well as surety products (protecting owners from the risk of being shut down).

It entered the construction market in a similar fashion... it identified an underserved area of the specialty construction market, and developed a “captive” product for its larger customers (whereby the customers form a subsidiary within their own corporate structure, specifically designed to provide insurance protection ... all with the backing of SKWD) and developed a product that it offered in conjunction with its traditional construction product. SKWD focuses on crane operators, general contractors for infrastructure work, and renewable energy contractors.

2: Conservative Investment Portfolio

Maintaining a conservative investment portfolio is good business practice for a company that is highly focused on underwriting profitability. For a company like SKWD, the risk should be in the underwriting side of the business, not on the investment side.

Like all insurance companies, SKWD collects premiums – and invests those funds until (and if) they need to pay a claim. We explain the details of “float” in our Guide to Property & Casualty Insurance.

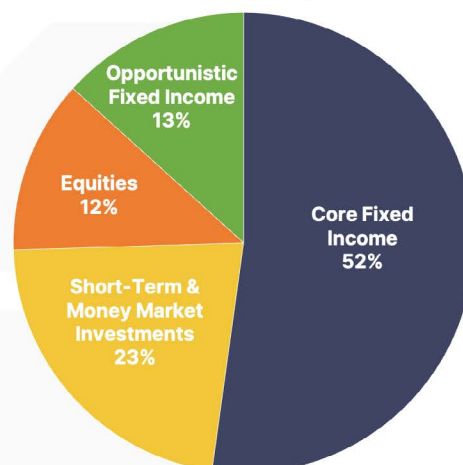
SKWD maintains a relatively conservative investment portfolio, with a short duration of 3.1 years and a 3.5% yield. With such a short duration on its fixed-income assets, we expect the yield to gradually increase as the “held-to-maturity” assets have matured and then reinvested at the higher prevailing interest rates of today.

The core fixed income portfolio consists primarily of investment grade fixed income securities which are predominantly highly-rated and liquid bonds. The weighted average credit rating of the core fixed income portfolio is “AA.” The core investment portfolio consists of its fixed income investments and its short term and money market investments and makes up almost 75% of all invested assets.

The rest come from equities and SKWD’s opportunistic fixed income holdings, which consist of separately managed accounts, limited partnerships, promissory notes and equity interests. The underlying securities are primarily floating rate senior secured loans, comprised of short duration and collateralized for a more conservative investment strategy.



Skyward Investment Portfolio as of March 31, 2023



3: Experienced Management

Because the E&S market is more complicated than the standard markets, having a management team that is deep and experienced is vitally important. In Skyward's case, the upper management team has almost 30 years of experience on average at some of the best E&S insurers in the business, including Hanover Group, Chubb, AIG and Zurich Group. CEO Andrew Robinson has 30+ years of experience in the industry, including time at The Hanover Group and Chaucer, where he oversaw specialty operations. John Burkhart, President of Specialty Lines, also has 30+ years of experience, including 20+ years at Chubb (an industry leader in underwriting expertise, where he was VP of Specialty Lines). Kirby Hall, President of Programs and Captives, spent time at AIG and ORI and also has 30+ years of industry experience.

CEO Robinson has already proven his mettle at leading the organization in the right direction. He immediately took two major actions that will positively impact future profits.

First, he went against the grain and exited unprofitable lines of business. These included professional liability for lawyers and insurance brokers and some areas of product liability, among others. Very few insurers have the discipline to pull out of insurable markets when they do not meet the profitability requirements of management.

That's because the agents (the main distribution channels for E&S insurers) do not like it when an insurer leaves a market because it means they have to work to place an already-difficult risk with a new insurer. And if that market – say professional liability for lawyers – turns around and becomes profitable again, often the wholesale agent will remember that the insurer left him high and dry. So most managements will simply keep writing unprofitable business to appease the distribution channel.

Second, upon exiting the business that he deemed unprofitable, the CEO bought what is called a Loss Portfolio Transfer (LPT).

In simple terms, SKWD transferred the amount of loss reserves it had put up for future losses in the exited business to a company in Bermuda that specializes in running off longer term liabilities. SKWD signed a deal to transfer any risk associated with future claims arising from the exited businesses. The company gave the Bermuda company about \$100 million of cash to absolve it of future claim payments from that business.

This was a very astute move, since the graveyard of insurance companies is full of those that have exited certain businesses, but still contend with the liabilities for years, hurting their overall profitability. SKWD will not have to deal with that problem.

As an example of why LPTs are a good idea, ACE Limited and XL Capital were two large insurers in 2008. They had written financial guaranty business for several years. (Financial guaranty insurance is a guarantee on financial obligations, typically related to debt obligations.)

When the 2008 financial crisis hit, financial guaranty companies were on the hook for paying the financial claims on defaulted bonds, of which there were trillions of dollars of exposure. ACE had exited the business a couple of years earlier but got a huge LPT to protect it from any future losses. XL Capital had also exited the business a couple of years earlier but did NOT get an LPT protection – and nearly went bust because of it.

One of the most important aspects of a truly successful P&C insurer is the experience and track record of management. For this reason, we believe SKWD is in an excellent position to thrive in the upcoming favorable phase of the underwriting cycle for E&S carriers.

Here's how we'll profit...

Action to Take

SKWD offers insurance to niche sectors of the economy where there is a clear competitive moat that prevents much competition due to the expertise needed to write SKWD's highly specialized products. At the same time, many standard

insurers are leaving certain markets, and leaving a void that will be filled by SKWD and other specialty and E&S insurers.

Hence, not only will the addressable market become larger but SKWD will have better pricing power as a result of the more favorable supply/demand dynamics.

Meanwhile, given the early stage of the company, its results are relatively untested. As such, its stock does not trade at the premium multiple that its few peers trade.

Additionally, the demand for SKWD's products is increasing rapidly, and should continue to do so over the foreseeable future. The world is becoming an increasingly riskier place. Traditional standard insurers are pulling out of many insurance markets as they do not have the underwriting expertise to successfully (profitably) offer certain types of insurance. The void created is an opportunity for specialty players like SKWD.

Therein lies the upside. We see SKWD's recent results as an early indicator that it is indeed on the right path to building out a strong specialized insurance company, one that ultimately will trade at the rich multiples of its peers. Now is a great time to get in on a stock that has wonderful long-term upside potential.

Action to Take: For the latest updates on our open positions, please visit our live portfolio [here](#).