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Arquitos

BEST IDEAS 2019 HOSTED BY MOI GLOBAL

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ARQUITOS CAPITAL - OVERVIEW

Background

- Arquitos Capital launched in April 2012
- Portfolio Manager/Chief Investment Officer: Steven Kiel
- Arquitos has controlled publicly-traded permanent capital vehicle, Enterprise Diversified (OTCQB:SYTE), since 2015
- Operations and investor relations managed by Willow Oak Asset Management

Investment Philosophy

- Arquitos Capital is an unconventional hedge fund invested in a small number of unique companies
- Seek aligned interests including high insider ownership, opportunistic share buybacks, investor-friendly policies, and other similar indicators
- Long-bias fund primarily focused on North American companies
- Long-term perspective focused opportunistically on company-specific bottom-up selection, applying deep fundamental analysis and due diligence
- Risk management based on the assessment of the probability of permanent capital loss

WESTAIM - OVERVIEW

Current Price (12/31/18): C\$2.58

Exchange: TSX Venture

52 Week Range: C\$2.29 – C\$3.35

Market Cap: C\$369 million

Book Value (as of Q3 2018): C\$3.10

Westaim is a Canadian investment company with two subsidiaries:

- Houston International Insurance Group (HIIG), a specialty P&C insurer; and
- Arena Group, a credit-focused investment manager

Westaim is also seeking new opportunities in the financial services industry. While any future investment is currently unknowable, Westaim's track record of effective capital allocation and their relationship with Fairfax Financial and other major funders bodes well for the future.

WESTAIM - HISTORY

Westaim began pursuing its current strategy when Canadian investment firm, Goodwood, took over the company in 2009.

In 2010 as a shell company, Westaim acquired JEVCO Insurance from Kingsway Financial for approximately C\$260 million. They financed the acquisition through an equity raise backstopped by Alberta Investment Management with a heavy contribution from insiders. JEVCO was sold in 2012 for approximately C\$530 million after they received an unsolicited bid. Proceeds were returned to investors.

WESTAIM - HISTORY

In 2014, Westaim partnered with Houston International Insurance Group. HIIG is a specialty P&C insurer run by industry veteran, Stephen Way. Way had been the founder and long-time operator of HCC Insurance.

Westaim then partnered with Dan Zwirn in 2015 to launch Arena Group. Zwirn had previously been the portfolio manager at D.B. Zwirn beginning in 2001. He had built a very strong track record until it wound up operations in 2008.

In 2017, the Canadian insurer Fairfax Financial made a strategic investment in the Westaim corporate entity and also made an investment in Arena Group. This partnership, as well as the other relationships that Westaim has with significant funding sources, provides the potential for upside surprises from new acquisitions, partnerships, and investments.

WESTAIM - HOUSTON INTERNATIONAL INSURANCE GROUP

On April 16, 2018 Westaim announced that HIIG had received “several unsolicited enquiries” and that Westaim “may consider opportunities to enhance the growth and value of HIIG.”

HIIG retained Credit Suisse in June 2018 and indicated that one option was to take on “a majority investor to support a subsequent IPO.” There has not been an update since then and it is unclear if HIIG is still working with Credit Suisse.

Westaim’s values its stake in HIIG at 1.1x book value (C\$222 million), or C\$1.55/share. My view is that Westaim would divest its stake if it received an offer at 1.8x book value (C\$363 million). This equates to total proceeds of C\$2.53/share, or close to today’s stock price for the entire company. This multiple may be aggressive, but Westaim is not a forced seller. Even a sale at 1.4x book would add more than 40 cents of book value to Westaim overall.

WESTAIM - HOUSTON INTERNATIONAL INSURANCE GROUP

Operationally, HIIG has improved their performance over the past few years as they have gained scale and reduced their use of reinsurance. HIIG generated gross written premiums of US\$661 million over the last 12 months. Their combined ratio is 96.9% year-to-date and net income through Q3 was US\$17 million.

HIIG has been increasing the percentage of gross written premiums that are considered specialty lines. In the most recent quarter, 51% of gross written premiums were in specialty lines, which are generally more profitable for the insurer and would demand a premium valuation in a sale.

WESTAIM - ARENA GROUP

Arena Group provides corporate private credit, real estate credit, and structure finance solutions. They focus on niche, underserved markets and strive for uncorrelated returns in the mid-teens. Dan Zwirn and his team have a significant advantage over the competition because of their ability to be flexible with the structure of their products and their asset class, industry, and geography. Their direct relationships and internal sourcing also serves to reduce risk and increase the diversity and opportunity for gains.

WESTAIM - ARENA GROUP

Arena consists of three entities:

- Arena Finance is internal capital that primarily purchases loans from Arena Origination and other sources. The fair market value as of Q3 2018 is approximately C\$220 million. Westaim currently owns 100% with Zwirn and others having options to acquire up to 16.7% of the entity over time.
- Arena Origination is also currently 100% owned by Westaim and serves as the origination arm of Arena. Westaim's stake is valued at C\$48 million at the end of Q3 2018.
- Arena Investors provides investment management services to third parties through pooled funds and separately managed accounts. Westaim has a beneficial ownership of 51%.

WESTAIM - ARENA GROUP

Arena's in-house approach requires scale, which they are just beginning to attain. Arena is expected to surpass US\$1 billion of AUM in 2019. Their marketing efforts have been significantly enhanced with the addition of former Bridgewater marketing head, Parag Shah. Parag joined Arena in April 2018.

Arena Group is also gaining additional publicity. Most recently they won HFM's "Newcomer Credit" award and they were recognized by Alt Credit as a top credit fund.

Dan Zwirn was interviewed by Manual of Ideas in March 2017. That interview can be viewed at <http://latticework.com/march-2017-daniel-zwirn-of-arena-investors>

WESTAIM - VALUATION

Westaim shares declined 22% in 2018 for reasons unrelated to the company's operational performance. Now trading for just 83% of book value, with the potential for another C\$0.98/share of book value if HIIG is sold, Westaim is as attractive as it has ever been.

Additionally, Arena Investors is on the cusp of profitability while the performance of Westaim's direct investment in Arena Finance has been strong.

Westaim has shareholder-friendly management who are effective capital allocators with aligned incentives. The company also has a partnership with Fairfax Financial that has the potential to lead to a new, attractive acquisition or partnership.

WESTAIM - VALUATION

Given these characteristics, Westaim deserves to trade at least at book value adjusted for the sale of HIIG, or C\$4.08/share. As the company continues to grow assets at Arena Group, a premium to book is well justified, as well as a more traditional multiple of AUM for Westaim's economic interest in Arena Investors.

Furthermore, Westaim's relationship with Fairfax and other funding partners provides an upside lottery ticket to this already safe investment.

INTERVIEW - WESTAIM CHIEF OPERATING OFFICER



Robert T. Kittel, CPA, CFA
Chief Operating Officer

ADDITIONAL RESOURCES

Toby Shute

Westaim: A Canadian Investment Company Providing Capital and Strategic Expertise, January 2015: http://www.valuwalk.com/wp-content/uploads/2015/02/the-manual-of-ideas_toby-shute_2015-01.pdf

Keubiko

Westaim: Heads I Win, Tails I Win More, September 2015: <https://seekingalpha.com/article/3490046-westaim-heads-win-tails-win>

Manual of Ideas

Dan Zwirn Interview, March 2017: <http://latticework.com/march-2017-daniel-zwirn-of-arena-investors>

Goodwood Funds

2017 Annual Report, <http://www.goodwoodfunds.com/wp-content/uploads/2017-Goodwood-Annual-Report.pdf>

Steve Vafier

The Westaim Corporation, March 2018: <https://medium.com/@svafier/the-westaim-corporation-526ea5820801>

The Westaim Corporation Update, May 2018: <https://medium.com/@svafier/the-westaim-corporation-update-39be25260e36>

Chris DeMuth, Jr.

2019 Top Pick, December 2018: <https://seekingalpha.com/article/4229626-2019-top-pick-westaim>

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