

Unico American Corp

UNAM (US: NASDAQ)

Report as of November, 9th 2006

Investment Success

First Purchase: Fall of 2004 @ ~\$5.90/share

Last Sale: Winter of 2005 (Sold less than 5% of total shares) @ ~\$9.30/share

Current Price: ~\$10.50/share

Company Background:

Unico American Corp is a small Property and Casualty (P&C) insurer in the state of California. The company has been in business for more than 25 years, and has been increasing its value for much of that time period. Unico is controlled by the Irwin family which control >50% of the company's common stock (the same shares you can buy on the open market).

Investment Thesis:

When Unico American stock was trading around \$6.00/share in 2004, the market value of the entire firm was approximately \$33 Million (based on 5.5 Million shares of stock outstanding). For this \$33 Million price tag, you could get a company with the following characteristics:

- 1) Heavy insider ownership and insider buying at market prices
- 2) Earning power of ~\$5.5 Million (\$1.00/share) in 2005
- 3) Clean balance sheet – Substantially all of the investments held by the company were in short term US Treasuries
- 4) Possibility of improving business results

Why was the Stock so Cheap?

Several reasons contributed to Unico shares selling at a discount, and there was a good chance that within a reasonable timeframe, the market would see through these issues and value the company at a fair price.

- 1) Unico attempted to expand their insurance business out of California in the late 90's and failed badly. There were different rules in the other states surrounding things like liquor liability laws for small businesses that Unico did not fully understand before writing insurance policies on them. Consequently, Unico wrote a lot of insurance to cover risk that they were not properly compensated for.
- 2) In 2003 Unico only made ~\$0.15/share in earnings... hardly the performance that would justify a \$6.00+ stock.
- 3) There were also doubts about the competency and honesty of management (who owned >50% of the stock), so many investors chose to walk away from the investment as opposed to trust management.

Laying the Concerns to Rest:

However, with a little digging, all of these concerns could be laid to rest.

- 1) Management DID indeed make a big mistake, but after it was realized they took the appropriate steps that you would expect from honest managers. They notified shareholders of the mistake, and detailed the steps they were taking to mitigate the risk and insure that it would not happen again. This management team after all owned (and still owns) over 50% of the equity in the company and they had more to lose than anyone.

- 2) While Unico's earnings in the previous 12 months were very low, their earnings looking forward into the next few years were very bright. Unico makes money by both profitably selling insurance contracts/policies (ie, selling a policy for \$10 today, that only requires payouts of \$9 over the life of the policy), and investing the insurance policy premium today (called 'float') while waiting for claim payouts in the future. In 2004, Unico was breaking even on their policy profitability and making all of their money investing the float for a profit (this is a standard insurance strategy). Interestingly enough, Unico invested their float in extremely conservative securities... all short term treasuries which at the time were paying about 1-1.5% interest due to the abnormally low short term interest rates that the Federal Reserve had set. However, it was a foregone conclusion at that time that the Fed was going to be raising interest rates to ~4% which would TRIPLE the profitability of Unico's investments.
- 3) While management credibility was being called into question, Unico's management had done two things to show that they were on the same side as the common shareholders. First, when Unico was strapped for cash and banks were resistant to loan the company money at reasonable rates. The CEO personally loaned the company \$1 Million at the VERY low rate of LIBOR + 1.5% (this would be similar to PRIME *minus* 1.5%).... At the same time instead of selling stock, or options and cashing out of the company's stock, the CEO was using his own cash to buy Unico shares on the open market. Also, his salary of \$300,000/year, while high by a layman's standards, was by no means offensive for a company with \$60 Million in revenue.

All these reasons, coupled with the fact that Unico American is for the most part, a company no one had ever heard of, and a company that all Wall Street analysts ignored, meant that there were not a lot of buyers for Unico's stock, which made it rather cheap and attractive to purchase.

Conclusion:

Unico American at \$6.00/share offered a chance to buy a decent company, at a substantial discount to its earnings power, which was also owned and operated by shareholder friendly management. Today the shares trade for around \$10.50 each, yielding a total return of 80% in two years. While they are not as cheap relative to the value of the business as they once were, they are still undervalued. The company is on a path to earn >\$1.50/share in earnings for 2006, placing it at only 7 times it's earnings, compared to the average earnings multiple in the S&P500 of >18 times.

NOTE: Benjamin R Hacker owned shares of Unico American Corp at the time of this writing. This is not an offer to buy or sell securities. Each individual's investment situation is different, and not all investments are suitable for everyone.