

Pico Holdings: An Asset Play? Compiled by Richard M. Rockwood for FocusInvestor.com

I came across Pico Holdings in one of my many searches for companies that could be potential investments. I found it sufficiently interesting to order its annual reports and examine the company in more detail. I have brought together the information I gathered for this article. I trust you will find the company as intriguing as I do.

When examining the company I think investors should examine closely the regulatory situations concerning their water rights and other similar issues. A series of negative regulatory rulings could cause problems for Pico. I would also caution the investor to examine closely the issue of what the land in Nevada is truly worth as much of Pico's valuation comes from that area.

I currently own no holdings in this company and I will not add it as a position in my portfolio until thirty days (if at all) after this report has been posted on my site. If readers desire to make an investment in this company they should take note of its low daily trading volume.

Business Summary

PICO Holdings, Inc. is a diversified holding company that acquires interests in companies that its management believes: are undervalued at the time the Company buys them; and have the potential to provide a superior rate of return over time, after considering the risk involved. The Company's major activities are: owning and developing land and the related mineral rights and water rights through Nevada Land & Resource Company, LLC; owning and developing water rights and water storage operations through Vidler Water Company, Inc.; property and casualty insurance; "running off" the loss reserves of the Company's medical professional liability insurance companies; and making long term value-based investments in other public companies.

Pico's Financial Objective:¹

John Hart, CEO:

“Our objective is to provide superior long-term growth in book value per share for a given level of risk. Another way to look at it is to outperform alternative investments while incurring the same or less risk. We believe that our holdings in aggregate should have less risk than the popular equity averages and we want to outperform those averages over the long run, say 5 to 10 years.”

Ron Langley, Chairman:

“Our objective is also to generate a sustainable earnings base, however our strategy for growth places less emphasis on earnings than a typical operating company as significant contributions to shareholders' equity are expected from unrealized appreciation in assets. The timing of realizations is determined more by maximization of the outcome than accounting and reporting periods. Although we are not a typical operating company, we should not be confused with a closed-end fund. We are active investors and business managers.”

Stats & Facts

Book Value:	\$16.57
Shares Outstanding:	\$12.4 million
Daily Volume:	Approx. 19,000 shares
52 Week Range:	\$9.625 - \$14.70
Price/Book:	.84

¹ PICO Holdings, INC, Company Profile, March 17, 2000

Insider Activity: Buying between \$11.00 - \$13.50
Institutional Owners: Ruane, Cunniff & Co, Inc - Approx. 203,000 shares

Management Bio's²:

Ronald Langley, Chairman of the Board of Directors

Mr. Langley was born in Australia and moved to the United States in 1984. He was a securities analyst before he joined Industrial Equity Limited ("IEL") which had a strong belief in the merit of the "Graham and Dodd" approach to investing. In 1979 he assumed control of IEL's worldwide investments. From 1979 to 1989 book value per share grew at an approximately 36% annual compounded growth rate.

Mr. Langley was the Chairman of Physicians Insurance Company and this is how he became connection with PICO.

Mr. Langley owns 3,975,383 or 31.1% of the company.

John Hart, Chief Executive Officer

Mr. Hart and Mr. Langley became associated as a result of Mr. Langley's IEP investments in North America in 1984 and 1985. Mr. Hart was employed at Detwiler, Riley & Company, a firm that provided investment-banking services to small and mid-cap companies. The firm was also a developer of software that identified potential acquisition candidates using Graham & Dodd techniques.

Mr. Hart and Mr. Langley joined together to find companies to purchase that met their investment criteria. This led them to take control of Physicians Insurance Company in 1995.

Mr. Hart owns 3,966,217 or 31.0% of the company.

Executive Compensation:³

Base Compensation: A fixed rate to be paid annually. Future Adjustments will take into account movement in executive compensation levels, changes in job responsibilities, and the size of the company.

Incentive Awards: Based on growth of book value per share in a fiscal year. Awards are earned when a pre-determined threshold is surpassed. If book value per share of the company exceeds this threshold, the incentive award is equal to 5% of the increase in book value per share multiplied by the number of shares outstanding at the beginning of the fiscal year.

The company has also given its employees unqualified stock options.

Operating Divisions

1. Land, Mineral, and related Water Rights

Pico paid \$48.6 million in 1997 to acquire Nevada Land & Resource Company, LLC. This company owned 1,362,753 acres of deeded land in Northern Nevada, which includes all the water, mineral, and geothermal rights. The average price paid per acre was \$34.92.

This acquisition made them the largest private landowner in Nevada with the government owing the majority of the land in the state.

² ibid

³ Pico 2000 10K p.89

The company then conducted a study and divided the land into seven sections and developed a strategy to maximize the value potential in each class.

Since the initial purchase the company has realized \$14.4 million from the sale of water rights, land, and land exchanges. \$12.4 million of the total amount received was from the sale of land, \$1.3 million from cash and land exchanges, and \$624,000 from the sale of water rights.

The average price received in land sales has been \$126.96 per acre. In 2000, 77.8% of the land was sold for cash with the company financing the remainder. The financing is collateralized by the land, and Pico charges a 10% interest rate, and a 20% minimum down payment. Nevada Land recognizes revenue on the sale of land when the loan closes.

As of December 31, 2000 they still owned 1,246,676 acres.

Nevada has been the fastest growing state over the past ten years, with the population growing by 66%. The company anticipates strong demand for land by power companies who wish to build generating plants where water is available and on land that has easy access to railroad lines.

The company has options agreements with Duke Energy North America to sell 480 acres of land for \$948 an acre and 2,896 acre-feet of water rights for \$120 per acre-foot. On February 2001 the Washoe County Planning Commission approved the above site for a plant to generate electricity for the Truckee Meadows and the surrounding communities.

Nevada Land has also filed applications for additional water rights. If these applications are granted it would certainly increase the value of the land. In the companies first quarter press release they had this to say on the application issue:

“The consummation of a transaction for the water rights which we recently filed for, could potentially result in significant value in excess of our indicative comparable market valuation for Nevada Land, which is approximately twice our book value.”

The wildcard involved in this companies operation:⁴

Mr. Hart, “The wild card, of course, is the mineral potential. We have identified several areas of our land that have development potential for both industrial and precious minerals. At this time, we don’t intend to enter into the mining business, but we have secured a handful of royalty agreements despite the current difficult times in the mining industry. Currently we place little or no value on these potential royalties, or on the minerals in general, but in one of the mineralogically richest area on the planet, you never know.”

2. Water Rights and Water Storage

Why water?

Mr. Langley, “The water industry is one where the U.S. is well behind a number of other countries. The laws are changing which will facilitate private transactions and allow economic factors to determine the price and ultimate end-user of water.”

Mr. Hart, “From an operating standpoint, through the sale or lease of water to municipal and industrial users, and from the lease of storage to similar users to meet periods of shortfall. Vidler Water Company itself also had value over and above its net asset value – we believe that it is the premier

⁴ PICO Holdings, INC, Company Profile, March 17, 2000

company in the business of developing and aggregating water for municipal and industrial use and for developing and managing underground water storage.”

Pico owns and develops water rights in Nevada, Arizona, and Colorado and has interests in water storage facilities in Arizona and California via Vidler Water Company which is 96.2% owned by Pico. (Sold 30% of the California water storage facilities in May 2001)

Population growth, environmental demands, and economic development should fuel demand for water supplies in these areas. The water sources in Northern Nevada are the only practical source of water to support the continued growth of Southern Nevada.

The company believes it can more efficiently allocate water supply, which at the current time is mainly controlled by agricultural users with municipalities not owning enough water rights. The company also believes the potential of interstate transportation of water to meet supply crunches is a significant opportunity that may increase water right values in spots that are currently undervalued going forward.

For information can be found at www.vidlerwater.com

Business description of Vidler Water from Pico's 2000 10K:

Acquisition of Water Rights Identify: water assets which may, at minimum, be immediately valued as equivalent to the purchase price; avoid assets which require conversion to a higher use to validate the purchase price. Emphasis on establishing a margin of safety on each investment by eliminating downside risk.

Development and Operation of Underground Storage Facilities Acquire storage and recharge capabilities that are often as important as water supply due to timing and location disparities between available supplies and highest demand. Without storage and recharge facilities, the problem of critical water shortages may only be half solved.

Water Asset Development and Management Services Provide professional services to municipalities and water districts lacking internal expertise and experience to make efficient use of their water assets. The initial objective of these services is to provide additional income with strong profit margins; an ancillary objective is to enhance Vidler's influence in the water industry.

Financial Services Accelerate the consolidation and privatization of the water industry by profitably monetizing rights owned by local governments through a series of sale/leaseback transactions.

Sale and Commercialization of Non-Water Assets Non-water real estate assets, typically purchased as part of water rights acquisitions, become surplus assets once the water rights are severed from the real estate. Vidler intends to actively pursue the sale or lease of real estate interests that are not required for the development or operation of its water assets.

Refer to page 6-7 of the 2000 10K for a list of Water Right Assets.

Major Water Rights Projects (Arizona)

Vidler owns, or has the rights to buy, 55,905 acre-feet of transferable ground water in the Harquahala Valley which is located approximately 75 miles northwest of Phoenix Arizona. They own 44,100 acre-feet, 2,019 acre-feet is in escrow, and have the option to purchase 9,786 additional acre-feet

The Arizona State Legislature recognizes this value as a special resource and has passed legislation committing the Central Arizona Project Aqueduct (“CAP”) to convey 20,000 acre-feet per annum of Harquahala groundwater to communities in Arizona. Vidler is able to supply this water and is meeting with the appropriate parties to arrange contracts.

Vidler sold 6,496.5 acre-feet of water rights to a unit of Allegheny for \$9.3 million, a \$2.4 million dollar contribution to pre-tax income during 2001.

Major Water Rights Projects (Nevada)

Through a joint venture it has filed applications for more than 100,000 acre-feet of water rights, which covers almost all of the unappropriated water in Lincoln County. They intend to use this possible supply to feed southern Nevada communities.

Also a tentative agreement to sell between 6,700 - 9,000 acre-feet of water to a power company for \$3,300 per acre-foot or \$22,110,00 to \$29,700,00 if they can obtain regulatory and financial approval. The closing date is to be around July of 2003.

Water Storage Projects (Arizona)

Vidler is building an underground water storage facility in the Harquahala Valley, which is located near the CAP aqueduct. This is a competitive advantage since it will lower the cost of getting water to the CAP system. The storage facility could also be used to effect transfer of water to other surrounding areas during periods of peak water demand.

Water Storage Projects (California)

Vidler has purchased a 18.5% right in a 1,000,000 acre-foot water storage facility at Semitropic near Bakersfield, CA. The company will have to make minimum annual payments of \$2.3 million during the first ten years.

3. Property and Casualty Insurance

Pico owns Sequoia Insurance, Citation Insurance, Physicians Insurance Company, and The Professional Insurance Company.

Sequoia's core business is conducted in California and Nevada in the niche markets of farm insurance and small to medium sized commercial insurance. The property side of Sequoia's business has in the past been minimal but has increased since Personal Express Insurance Services was acquired in 2000. They are focused on earning an underwriting profit and have generated an underwriting profit in 3 of the last four years. Eighty percent of its float is invested in bonds while the remaining 20% is invested in Pico's long-term investments and small-capitalization value situations.

Sequoia's GAAP Industry Ratios:⁵

	<u>2000</u>	<u>1999</u>	<u>1998</u>
Loss and LAE Ratio	67.6%	53.5%	52.3%
Underwriting Expense Ratio	38.6%	46.3%	43.4%
Combined Ratios	106.3%	99.8%	95.7%

Personal Express is a direct writer of insurance with two local branches in Bakersfield and Fresno providing service to their customer base

⁵ Pico 2000 10K p.28

Citation was also a property and casualty insurer but is currently not writing any new business.

Physicians Insurance Company and The Professional Insurance Company are currently not writing any new business.

4. Investment Operations

Company statement on what it looks when investing from the 2000 10K:

“PICO invests in companies which our management identifies as undervalued based on fundamental analysis. Typically, the stocks will be selling for less than tangible book value or appraised intrinsic value—that is, what we think the company is worth. Often the stocks will also be trading for low ratios of earnings and cash flow, or on high dividend yields. Additionally the company must have special qualities, such as unique assets, a potential catalyst for change, or it may be in an industry with attractive characteristics.

We invest for the long term, typically 5 years or more, and seek to develop a constructive relationship with the company. This may include an appropriate level of shareholder influence, such as encouraging companies to use proper financial criteria when making capital expenditure decisions, or providing financing or strategic input. In the case of larger holdings, this will usually include board representation.

Before a substantial sum is invested, after significant research and analysis, we must be convinced that—for an acceptable level of risk—there is sufficient value to provide the opportunity for superior returns. On rare occasions, we will deviate slightly from our strict value criteria. In these cases, given the higher level of risk, we invest smaller sums.

We sell investments if their price has significantly exceeded our objective, or if there have been changes in the business or in the company which we believe will limit further appreciation potential, on a risk-adjusted basis.”

Long-Term Investments

Mr. Hart had this to say on their investment strategy:⁶

“Our strategy is to acquire or invest in undervalued assets that have the potential for long-term superior rates of return. Specifically we are Graham and Dodd-style investors who seek to limit downside risk through giving ourselves the greatest possible margin of error through “intelligent investing”. The flip side is when things go well, meaning the cycle turns so that assets which were unloved or undiscovered or misunderstood become the current favorites, superior returns can be realized. In addition, attention to improving asset performance when required can lead to above-average returns without the benefit of an improved macroclimate. This type of improved asset performance can result from change in Board direction, improved financing, and other forms of restructuring.”

Mr. Hart & Mr. Langley on Investment Criteria:⁷

Mr. Hart: “The most important is a purchase price that will allow us to generate at least a 20% compound rate of return with a modest level of risk. The objective is to be able to acquire an asset at a discount to net asset value, or on a low multiplier of cash flow and earnings, with the most emphasis being on discount to net asset value. We also prefer more established industrial operations or assets where technological obsolescence is not an issue.”

⁶ PICO Holdings, INC, Company Profile, March 17, 2000

⁷ *ibid.*

“Depending on opportunities available at the time, or in the foreseeable future, we are prepared to deviate from these guidelines *slightly* (authors italics) to invest in areas where the value is more intangible than tangible, for example our investment in HyperFeed Technologies. This approach may involve higher business risk so we are prepared to commit a modest investment amount which, in the worst possible case, we realize could be lost entirely.”

Mr. Langley: “We seek to identify publicly-traded stocks in North America and overseas markets which are undervalued in comparison to book value or intrinsic value, and where there is an element that makes the company more attractive. For example, the company could be in an industry that we really like, it could be a natural turnaround situation, or it could have unrecognized unique qualities. Unless we like all aspects – including management, product, currency, commodity, distribution, region, accounting policies etc. – there must be a potential catalyst for change, including actions that we may initiate ourselves. Finally, the balance of probability must be that a majority of factors will move in our favor.”

HyperFeed Technologies:

Market Value: \$33.3 million (as of July 6, 2001)
Purchase Price: \$10.4 million in 1995

HyperFeed provides Internet content and solutions to the financial services industry. HyperFeed offers a number of business-to-business solutions for the delivery and display of financial data. HyperFeed’s business-to-consumer subsidiary PCQuote.com is an Internet-based provider of high performance, real-time financial data and has a popular website (www.pcquote.com).

Pico owns approximately 11,456,795 shares according to HyperFeed’s 2000 Proxy Statement.

Here is the story behind Pico’s investment in HyperFeed:⁸

“How did a Graham and Dodd investor come to invest in a technology company? Pico acquired its stake when the then major stakeholders attempt to divest its investment had depressed the price. Given that a meaningful stake was available in a then profitable company, which Pico determined had an underlying business value significantly higher than the market price, a manageable sum was invested.”

Jungfraubahn Holdings AG:⁹

Market Value: \$US 15.3 million (as of Dec. 31, 1999)
Purchase Price: \$US 14.9 million

Market Value: \$US 18.9 million (as of Dec. 31, 2000)
Purchase Price: \$US 17.4 million

Jungfraubahn is a transport and tourism company which provides rail and associated services for sport and other excursions in the Jungfrau region of Switzerland, including the Jungfrauoch-Top of Europe experience, a train ride to Jungfrauoch which is 11,333 above sea level. Jungfrauoch exhibits remarkably consistent cash flow despite the fact that a number of important factors affecting revenues are outside the company’s control – most notably visitor arrivals in Switzerland and weather.

Pico owns approximately 19.76% of the company after including the purchases it made in the first quarter of 2001. Please visit www.jungfraubahn.ch for more information on the company.

⁸ *ibid.*

⁹ *ibid.*

Australian Oil and Gas Corporation Limited (“AOG”):

Market Value: \$US 8.2 million (as of December 31, 2000)
Purchase Price: \$US 7.6 million

AOG is a drilling contractor and it is the largest onshore drilling contractor in Australia with 12 rigs in operation, and a further 18 rigs in six other countries.

On February 20, 2001 AOG reported its six-month results to December 31, 2000. Over this time period AOG’s revenues increased 93%. AOG has also announced that rig utilization rates jumped to 70% from 54%.

Pico is the largest shareholder, with an 18% stake (981,584 shares) in the company.

Accu Holding AG:

Market Value: \$US 4.9 million (as of December 31, 2000)
Purchase Price: \$US 4.7 million

This company manufactures batteries at two plants in Switzerland. Pico owns approximately 28.3% of the company.

SISCOM, Inc:

This company is a software developer and system integrator for video-based content management systems for the professional broadcast, sports, and entertainment industry. SISCOM’s proprietary technology includes integrated tools for real-time logging, data management, archive management, browsing, search and retrieval, and analytics/data mining tools.

PICO owns more than 60% of the company, which is not currently profitable.

Mendell Technologies, INC:

Carrying Value: \$657,000

Mendell is a private oil and gas company.

Other:

Pico owns 2,500,000 shares and 1,000,000 warrants in Solpower Corp (Ticker: SPLW.OB), a publicly traded Arizona-based distributor and manufacturer of refrigerant gas and fuel additives. The stock price on July 6, 2001 was 24 cents.

Carrying Value: \$1,100,000 after taxes on December 31, 2000.

Pico owns a 50% interest in Protocol Resource Management, the largest refrigerant repackager in Canada, which is in connection with Solpower. PICO paid approximately \$338,000 for its shareholding.

A short term loan of \$2.2 million to Dominion Capital Pty. Limited, Solpower’s major shareholder, which are due to be repaid in 2001.