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NAME: KINGSWAY FINANCIAL	SYMBOL: KFS (NYSE)
MARKET CAP (4/17/14): $86 MILLION	PRICE PER SHARE (4/17/14): 5.24
FLOAT: 6.85 MILLION	AVG VOLUME (3 MONTHS): 23,800

KINGSWAY FINANCIAL SERVICES INC.

The Conclusion First

As I so often like to do when presenting research to investors, the conclusion of this report deserves to be mentioned first.

KFS presents a completely restructured opportunity in the insurance services/underwriting sector within five separate companies that make up KFS. Debt has been reduced by nearly 70% since 2009. Management has been reorganized over the past few years, led by a successful activist investor in the financial space Joseph Stilwell. Management owns nearly 40% of the company, with an additional $7 million invested over the past year. And the company is sitting on $861 million in net operating losses that can be utilized for many years to come.

The restructuring of debt, business model and management have been administered with one purpose in mind: Growth. This future growth will be leveraged by: 1) Permanent capital that will be reinvested at a high rate of return 2) NOLs that will provide tax free income over the next decade.

Let's move onto the details of what can become of KFS over the next 3-5 years.

Opportunity In Insurance

In recent years, I have become increasingly fond of the insurance space as an investment vehicle that can provide gains above any comparable benchmark. Not just any insurance, however. I will not simply judge an insurance company on the basis of discount to perceived book value followed by an investment in the company due to that discount. There needs to be more to the puzzle.

Specifically, I am looking for three things:

1. A company that went through a highly distressed period, where the survival of the company was in doubt. As a result of the distress, NOLs above and beyond the current market cap of the company have become available.
2. A company that has restructured its operating divisions in such a way as to provide maximum efficiency towards profitability going forward.
3. A company that has a management team in place, preferably led by an experienced activist investor or board of directors that is aggressively seeking a turnaround and is heavily invested in that eventuality.

Further, insurance is a sector that when all three of these factor combine, the outcome is explosive in nature. I hate to use the word asymmetric or optionality because they have become the investment catch phrases of our time. In this instance, however, I will join in the verbal pomp to describe the opportunity in KFS within the insurance sector as asymmetric in nature.

The insurance sector is unique in that when you combine all of these factors they essentially act as a leveraged investment vehicle that can be tremendously profitable. The access that management gains to permanent capital that can then be invested in everything from real estate to equities only serves to compound the potential profitability.

There is a very specific reason major hedge funds have setup offshore reinsurance entities. They want permanent capital within a tax efficient structure. Without the threat of the transitory nature of capital investment, hedge funds then become free to pursue risks that they normally wouldn't be able to take on.

Warren Buffet originally ran a hedge fund up until 1969. At that time, he decided to convert to an insurance business called Berkshire Hathaway. The reason was that insurance provides access to capital that investors will never redeem. This allows a talented investor to compound gains, eventually becoming one of the richest men in the world, as Warren Buffet has become.

The Business Of Kingsway

There are currently five businesses that make up KFS. Of those five, only one is a legacy business that existed prior to current management taking over. This is a completely restructured company, in other words.

The five companies consist of two underwriting businesses and three service businesses:

1. **Mendota** – Auto Insurance/Legacy Business - Underwriting
2. **1347** – Property Insurance – Underwriting
3. **IWS Acquisition** – Motor Vehicle Warranty Services - Services
4. **Trinity** – Warranty Products and Support for HVAC and Refrigeration Industry - Services
5. **Assigned Risk Solutions** – Property & Casualty Insurance - Services

- **Insurance Underwriting Business/Mendota/1347**: This is one of the insurance underwriting segments of the company. Insurance underwriting principally offers personal automobile insurance to drivers who do not meet the criteria for coverage by standard automobile insurers. For the year ended December 31, 2013, non-standard automobile accounted for 84.1% of the Company's gross premiums written.

  Non-standard policies are generally a high margin business in terms of fees produced, installment and/or cancellation fees, sales of complimentary products.

  Non-standard automobile insurance is principally provided to individuals who do not qualify for standard automobile insurance coverage because of their payment history, driving record, place of residence, age, vehicle type or other factors. Such drivers typically represent higher than normal risks and pay higher insurance rates for comparable coverage.

For the year ended December 31, 2013 , gross premiums written for non-standard automobile insurance decreased 6.1% to $121.7 million as compared to $129.6 million in 2012.

Allied lines includes policies that provide coverage for wind and hail-related property losses of residential dwellings and certain contents as well as premium related to Amigo's participation in the National Flood Insurance Program. For the year ended December 31, 2013 , gross premiums written from allied lines increased by 35.0% to $13.9 million compared to $10.3 million in 2012. This increase primarily reflects the Company's entry into the wind and hail-related insurance business in October of 2012 with the new business formation and licensing of Maison/1347 and subsequent participation in a depopulation of in-force wind and hail policies from Louisiana's state-owned insurance facility, Louisiana Citizens Property Insurance Corporation.

Homeowners premium includes dwelling, homeowner and mobile home/manufactured home policies for multi-peril property risks. For the year ended December 31, 2013, gross premiums written for homeowners insurance was $9.1 million compared to zero in 2012. This increase reflects Maison's/1347 entry into the homeowners insurance business during 2013.

In total insurance underwriting gross premiums written were $144.7 million compared to $145.9 million for the year ended December 31, 2012, representing a 0.8% decrease. Net premiums written were $113.6 million for the year ended December 31, 2013 compared to $115.3 million for the year ended December 31, 2012, representing a 1.5% decrease. Net premiums earned were $109.6 million for the year ended December 31, 2013 compared to $114.9 million for the year ended December 31, 2012, representing a 4.6% decrease.

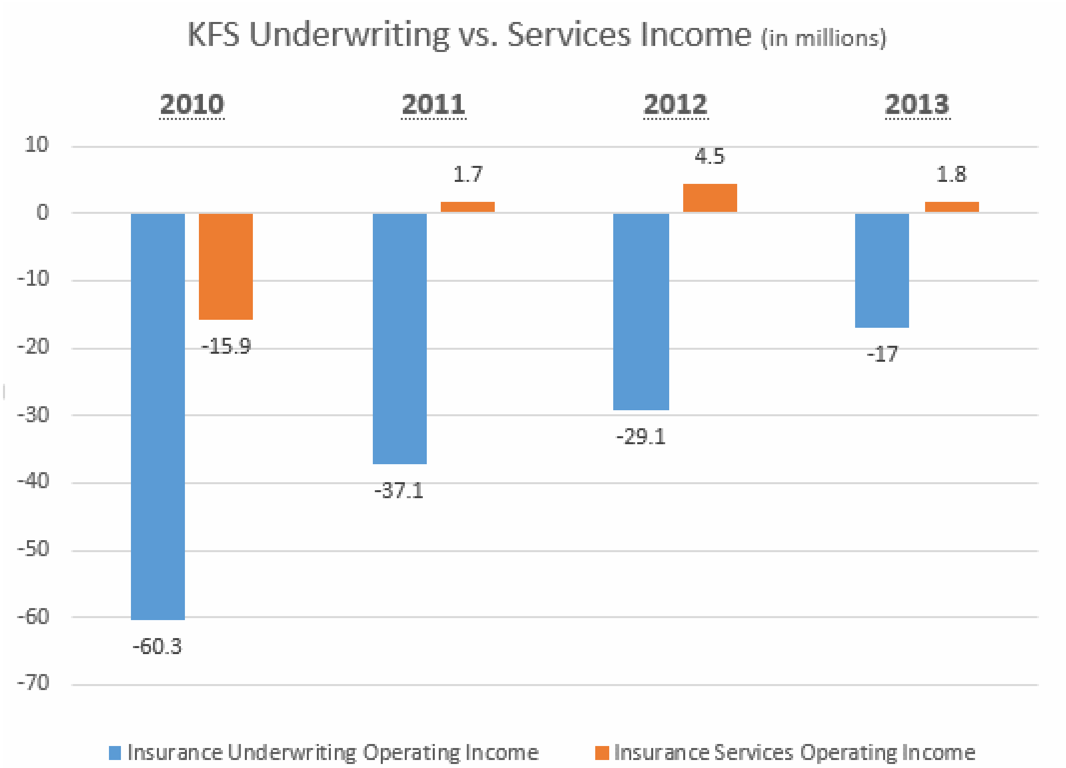
The Insurance Underwriting *operating loss* decreased to $17.0 million for the year ended December 31, 2013 compared with $29.1 million for the year ended December 31, 2012. The decrease in operating loss is primarily attributed to a decrease in loss and loss adjustment expenses, as reflected in the loss ratio, against a smaller volume of net premiums earned.

In summary, we are seeing a smaller loss against a slight decline in premiums written, as management is becoming more efficient in choosing profitable premiums. This is a very important highlight. The efficiency on the underwriting segment will allow the services segment to flourish unencumbered, which seems to be part of the grand plan of KFS going forward.

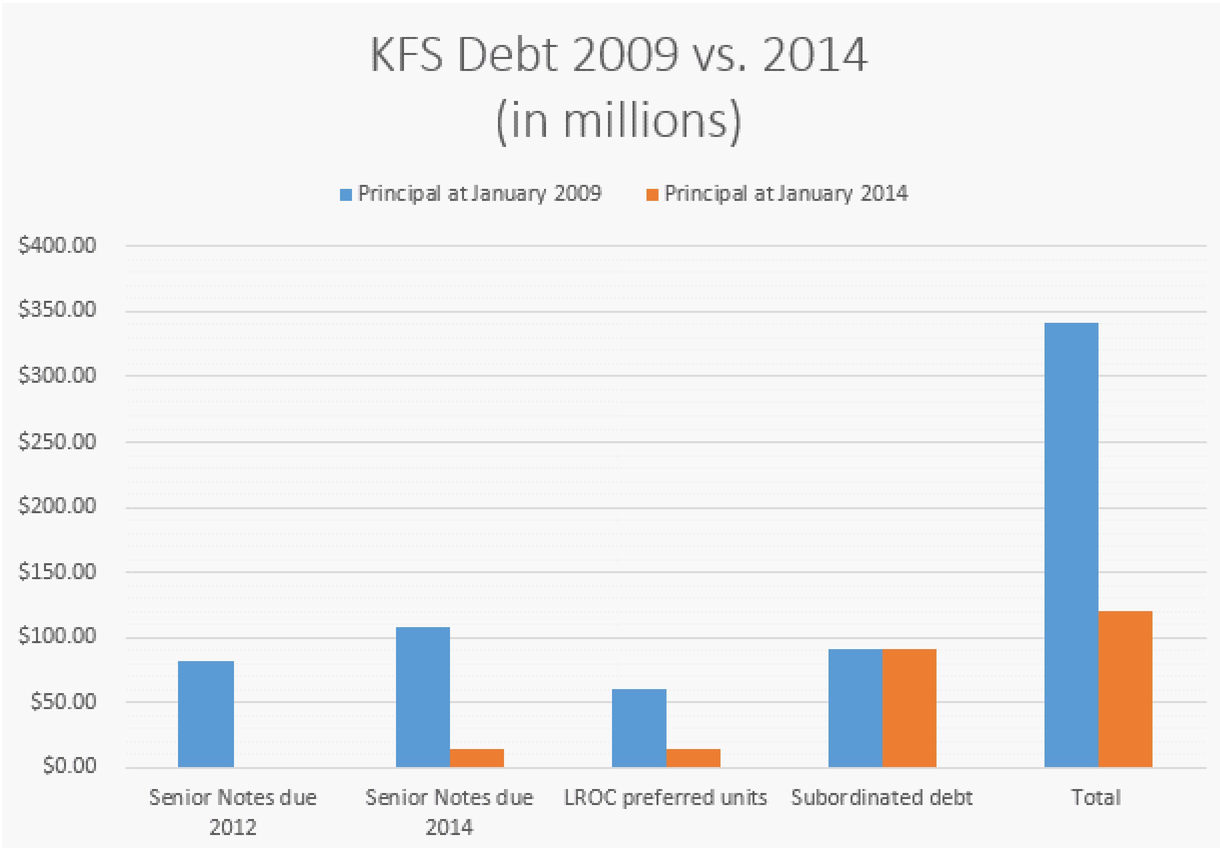
Here is a look at the service segment:

- **Services Business/IWS/Trinity/ARS:**The Insurance Services service fee and commission income increased 39.4% to $49.5 million for the year ended December 31, 2013 compared with $35.5 million for the year ended December 31, 2012. This increase was primarily driven by the inclusion of IWS in 2013 following its acquisition during the fourth quarter of 2012. The Insurance Services operating income was $1.8 million for the year ended December 31, 2013 compared with $4.5 million for the year ended December 31, 2012. The decrease in operating income in 2013 is due to reduced premium volumes managed by ARS, increased loss and loss adjustment expenses at IWS and operating losses at Trinity, which was acquired during the fourth quarter of 2013.

These service companies are all newly acquired businesses under the KFS umbrella.



Reduced Debt Liability



It should be noted that the Senior Notes due 2014 debt liability was reduced from $14.4 million to zero recently. Decreasing KFS's total debt liability to $105 million.

The subordinated debt remaining on the balance sheet is the biggest remaining burden to KFS. Interest payments are currently being deferred on the sub debt until 2016. This does not constitute a default. This from the 10-K:

During the first quarter of 2011, the Company gave notice to its trustees of its intention to exercise its voluntary right to defer interest payments for up to 20 quarters, pursuant to the contractual terms of its outstanding indentures, which permit interest deferral. This action does not constitute a default under the Company's indentures or any of its other debt indentures. At December 31, 2013, deferred interest payable of $12.8 million is included in accrued expenses and other liabilities in the consolidated balance sheets.

The Tax Efficient Operating Structure

From the recent 10-K:

Our U.S. businesses have generated net operating loss ("NOL") carryforwards for U.S. federal income tax purposes of approximately $861.0 million as of December 31, 2013. These losses can be available to reduce income taxes that might otherwise be incurred on future U.S. taxable income. The utilization of these losses would have a positive effect on our cash flow. Our operations, however, remain challenged, and there can be no assurance that we will generate the taxable income in the future necessary to utilize these losses and realize the positive cash flow benefit.

Also from the recent 10-K comes this important point that directly relates to the NOL carryforwards:

On May 13, 2013, the Company's shareholders approved an amendment to the Company's Articles of Incorporation to create an unlimited number of zero par value class A preferred shares. The Company's Board of Directors will have the ability to fix the designation, rights, privileges, restrictions and conditions attaching to the shares of each series of preferred shares. The preferred shares will have priority over the common shares. No Class A preferred shares were issued or outstanding at December 31, 2013.

In the midst of a completely transformed operating and debt structure, KFS's management wants the right to issue an unlimited number of preferred shares.

There are two things this authorization tells us as shareholders:

1. KFS wants access to a large amount of capital to fund future acquisitions.

2. KFS is fully cognizant of IRS Section 382 rules dictating ownership changes relating to financing acquisitions when NOLs are present. Vanilla preferreds can be issued in large quantities without triggering what would be considered an "ownership change" in the IRS's view, jeopardizing the NOLs.

The bottom line here is that this approval of an unlimited preferred issuance is a strong indication that the NOLs are going to be worked through in less than a ten year timeframe facilitated by a large, transformative acquisition over the next 12-24 months.

The Investment Portfolio

The beauty of the insurance business is the access to permanent capital. That capital allows profitability to be achieved on multiple fronts as premiums from customers pour in. Kingsway carries its investment portfolio on the balance sheet of their Mendota unit. Within that portfolio, they invest in real estate, publicly traded equity, and bridge loans with equity upside.

In 2012-2013, the company had $14 million invested in non-fixed income assets. KFS saw a return on invested capital of 24% during that period.

$7.7 million of the $14 million was invested in assets other than real estate, producing a return of 40% during the same period.

This is a powerful operating model that insurance companies have the privilege of participating in. It is, however, only as good as the management that undertakes the analysis and execution of the investment strategy.

Management

In discussing management, I want to focus on activist investor Joseph Stilwell, as KFS seems to be his magnum opus.

Who is Stilwell?

Stilwell runs Stilwell Value which is comprised of numerous LPs that take or have taken positions in financial institutions. Stilwell is an activist investor who aggressively asserts influence over management and the board in order to institute changes that can positively influence shareholder value.

Since 2000, Stilwell Value through its various LPs has taken greater than 5% positions requiring the filing of a 13D more than 40 times. More often than not Stilwell's efforts have led to acquisition and/or restructuring of management and operations. Certainly looking through the past activist efforts of the company, he has been successful more often than not.

With KFS the efforts of Stilwell were described in an SEC filing from 2012:

On November 7, 2008, we filed a Schedule 13D reporting a position in Kingsway Financial Services Inc. ("KFS"). We requested a meeting with its CEO and chairman to discuss ways to maximize shareholder value and minimize both operational and balance sheet risks, but the CEO was unresponsive. We then requisitioned a special shareholder meeting to remove the CEO and chairman from the KFS board and replace them with our two nominees. On January 7, 2009, we entered into a settlement agreement with KFS whereby, among other things, the CEO resigned from the KFS board and KFS expanded its board from nine to ten seats and appointed our nominees to fill the two vacant seats on the board. By April 23, 2009, the board was reconstituted with just three of the original ten legacy directors remaining. Also, Joseph Stilwell was appointed to fill the vacancy created by the resignation of one of our nominees, Larry G. Swets, Jr., and our other nominee, Spencer L. Schneider, was elected chairman of the board. In addition, the CEO and CFO were fired for incompetence and insubordination. By November 3, 2009, all of the legacy directors had resigned from the board. On May 27, 2010, Mr. Stilwell and Mr. Schneider were re-elected to the board. On June 1, 2010, Mr. Swets was appointed CEO. During the time the Group has had board representation, KFS has sold non-core assets, repurchased public debt at a discount to face value, sold a credit-sensitive asset, disposed of its *subsidiary Lincoln General, substantially reduced its expenses, and reduced other balance sheet and operations risks.*

In a recent letter to shareholders, KFS CEO Larry Swets stated the following regarding Stilwell:

Terry Kavanagh (one of our board members), in trying to convince me to take on the challenge at Kingsway, shared with me a conversation he had with Joe Stilwell (our largest shareholder and a board member). In that conversation, Joe mentioned he wouldn't judge the success of Kingsway as a stock investment for 15 years. Terry said to me "I told Joe that was way too short; we wouldn't evaluate it for 20+ years." He was serious.

What The Future Holds

There comes a time in valuing any micro/small cap company where an investor must look beyond the obvious facts, into the wide open sea that is only portrayed by studying intentions. I call this intentional analysis. The analysis of the intentions of management that occur when looking at all the parts that make up the current structure of the company.

Those parts can include the history of the operators. The evolution of the financial/debt structure. The assets that have been invested in or divested away from.

All of these parts, when accurately assessed, can deliver to the astute observer the intentions of management. More importantly, it gives a glimpse as to the reality of what the future company will look like going well beyond the confines of traditional modeling.

In KFS, we know the following:

1. There is a very successful activist investor who has played a key role in the transformation of numerous financial companies in the past.

2. There is a dedicated, experienced management team in place that owns a significant portion of the company.

3. The company has been on an acquisition spree as of late, with 4 of the 5 operating divisions being new ventures.

4. A debt structure that has been completely transformed allowing for future flexibility.

5. The company has an unlimited amount of Class A Preferred Stock at their disposal that can provide capital for a large acquisition without violating Section 382 of the IRS code regulating the use of NOLs.

6. The company has nearly $900 million in NOLs.

If KFS was being run by a group of traditional MBA types I would concede the fact that the NOLs will be used over a reasonable time frame that would exceed 10 years, without running into the 20 years expiration ceiling.

KFS is being steered by a Wall Street guy, however. The difference between a Wall Street guy and the traditional MBA type is that the Wall Street guy realizes that the $900 million in NOLs won't be worth nearly as much 5, 10 and especially 20 years out. The Wall Street guy also is fully comfortable and capable of utilizing leveraged transactions to capitalize on the NOLs.

That's where the magic is in this deal. Contrary to what you may be seeing presently, this isn't being structured as a traditional insurance services firm that is going to slowly grow top and bottom line while making prudent investments that provide 1000-2000 basis points of return on their investment capital.

Everything from the pace of acquisitions, to the amount of NOLs, to the reduced debt structure, all the way up to top management, tells me that a game changing acquisition is going to take place at KFS.

If you'll recall, CIDM was an investment that I made in the portfolios last year. While the stock was treading water in the mid-$1 range, the company was making a series of small, mildly-transformative acquisitions similar to KFS. The key move that, in hindsight, was a dead giveaway to their game changing acquisition of Gaiam, was restructuring debt, making it non-recourse, so that they could facilitate a large future acquisition instead of taking a long series of baby steps that would prove tedious and exhausting to current investors.

The restructuring of the balance sheet, along with KFS's proclivity towards growth through acquisitions means that a large acquisition is not a matter of "if," but simply a matter of "when."

That acquisition can be financed in a number of ways that will preserve the NOLs, allowing KFS to deplete them at a far greater pace than is currently be suggested. The authorization of the preferred shares for the first time in this company's 25 year operating history is a notice to investors in bright neon that a substantial capital raise for the purposes of an equally substantial acquisition is in the offing.

With that acquisition comes the appropriate valuation for a completely transformed insurance company that has a decade of tax free income. It doesn't stop there, however. This isn't a tech company where future income will simply be allocated into the mediocrity that comes with R&D or share buybacks. With KFS we have an investment team in place that has proven competent in the past with investments in companies such as Atlas (AFH) pre-ipo. Their ability to leverage gains further through ROI on a portfolio of passive securities and real estate further enhances the upside.

It is the type of leverage on top of leverage scenario that induces trends in the appreciation of a company's market cap that are both substantial and consistent in nature. With that said, the entire restructured package is being sold at an $86 million market cap. As the story evolves, the stock price doesn't leave much in the way of downside, paired with potential upside that would make a traditional investor blush.

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