Randall & Quilter

7 July 2020

A record FY19 result and strong pipeline

Impressive FY19 results met expectations via a combination of record Legacy deals and growth in the scale, product range and geographical reach of Program Management income. The latter is key, as this builds a base for future growth in complementary, visible, and reproducible fee-based revenues and commissions.

The Legacy division's record year was the main source of growth in FY19. That business is by nature difficult to forecast, but R&Q is confident that its 30-year track record and high industry profile puts it in a strong position to accumulate further deals. Indeed, its legacy pipeline is already very busy as insurance entities globally seek to raise capital to manage the impact of the pandemic on their operations.

COVID-19: revenues prove defensive, looking to capitalise

Revenues are defensive. Legacy purchases relate to historic books in run-off, so have limited exposure to new claims related to the pandemic. Program Management writes new, live insurance business, but is largely reinsured with highly rated counterparties.

R&Q takes a pragmatic view regarding the short-term impact of economic turmoil on its business. It sees potential for delays in securing both legacy deals and new programs this year but, conversely, for disruption in insurance markets to drive business in its direction. Its strategy remains to grow both core businesses and pursue opportunistic acquisitions. It has accelerated plans to expand the breadth and reach of its Program Management operations. The rationale for April's $100m equity issue is to allow both units to benefit from the turbulence and enhance the Group's competitive positioning.

Valuation: unjustified discount to peer group, 6% yield

Our equity valuation is a sum of the parts, as the two divisions have distinct revenue models and earnings profiles. The current rating of 1.2x NAV is well below the average of 2x for industry peers, despite RQIH's superior performance: both divisions have produced above average growth/net returns relative to comparators over the last three years. Potential to rerate simply to sector levels indicates **a 66% undervaluation** for RQIH at present. Furthermore, the outlook is well supported by business booked in FY19 and Q1 2020 and underlying growth in program activity, and the opportunity is being pursued by an expanded Management team blessed with much relevant experience.

Summary forecasts

Year end 31 Dec	2017A	2018A	2019A	2020E
Operating Profit (EBIT) (£m)	14.3	18.6	49.7	46.8
Pre-tax (continuing) (£m)	9.8	14.3	40.1	37.2
EPS (p)	10.5	7.8	21.4	16.6
Yield on distribution (%) *	5.5	5.7	6.1	6.1
Net asset value per share (p)	105	139	148	142

*Source: Group report & accounts and ED estimates *final div paid in shares during the pandemic*

Company Data

EPIC	RQIH
Price	162p
52 weeks Hi/Lo	223p / 115p
Market cap	£322m

Share Price, p

Source: ADVFN

Description

Randall & Quilter Investment Holdings Ltd. (R&Q) is a long-established UK and US insurance business led by an experienced and growing management team.

It is focused on two core strategies: to drive commission income from writing niche books of business using its carriers licensed in all key regions and to grow an industry leading provider of exit solutions for legacy/ run-off insurance assets to vendors in the US, Bermuda and Europe.

Roger Leboff (Analyst)
0207 065 2690
roger@equitydevelopment.co.uk

Hannah Crowe
0207 065 2692
hannah@equitydevelopment.co.uk

FY19: strong results, positive start to FY20

FY19 results were in line with forecasts and included material revenue and profit growth, plus delivery of all strategic targets during the period. For reasons which we discuss in more detail below, an exceptional FY19 represents a realistic guide to R&Q's potential. R&Q sees the main impact of the pandemic in potential delays in completion of new business but expects any short-term impact to be more than offset by new underlying business drivers.

The period was R&Q's most profitable year to date. Group pre-tax profit from continuing operations was 180% up at £40.1m (FY18: £14.3m). Post tax was 399% ahead at £38.9m (FY18: £7.8m). Including returns to shareholders, NAV/share was 13% up y-o-y at 148.1p (FY18: 139.4p) and basic earnings per share up 269% to 21.4p (FY18: 5.8p).

That performance is a direct result of the strategic refocus, now into its third year, on two complementary, high growth specialty insurance activities: legacy purchases and program management. That has created a prospective mix of capital growth (in Legacy division) and steady, visible fee income (Program Management).

As the table below illustrates, in FY19, Legacy remained the main contributor to group results, although Program Management is growing rapidly. It recorded **147% y-o-y growth** in Gross Written Premium in 2019.

Segmental results FY2019

£'000s	Program	Legacy	Other	Consolidation adjustments	Total
Earned premium, net of reinsurance	**6,099**	**168,427**	**-**	**-**	**174,526**
Gross investment income	4,603	22,699	7,918	(13,227)	21,993
External income	1	58	6,721	-	6,780
Internal income	-	-	27,046	(27,046)	-
Total income	**10,703**	**191,184**	**41,685**	**(40,273)**	**203,299**
Claims paid, net of reinsurance	(2,831)	(69,390)	(183)	-	(72,404)
Net change in provision for claims	(3,444)	(65,533)	(1,775)	-	(70,752)
Net insurance claims (increased)/released	(6,275)	(134,923)	(1,958)	-	(143,156)
Operating expenses	(6,325)	(58,548)	(40,824)	27,046	(78,651)
Op. result - pre goodwill on bargain purchase	(1,897)	(2,287)	(1,097)	(13,227)	(18,508)
Goodwill on bargain purchase	-	71,332	-	-	71,332
Amort. and impairment of intangibles	-	(2,579)	(583)	-	(3,162)
Result of operating activities	**(1,897)**	**66,466**	**(1,680)**	**(13,227)**	**49,662**
Finance costs	(309)	(8,906)	(13,549)	13,227	(9,537)
Pre-tax profit	**(2,206)**	**57,560**	**(15,229)**	**-**	**40,125**
Income tax (charge)/credit	(353)	(10,734)	9,807	-	(1,280)
Profit/(loss) for the period	**(2,559)**	**46,826**	**(5,422)**	**-**	**38,845**
Non-controlling interests	-	515	(37)	-	478
Attributable to shareholders of parent	(2,559)	47,541	(5,459)	-	39,323
Segment assets	**412,130**	**1,586,860**	**93,420**	**(311,537)**	**1,780,873**
Segment liabilities	**318,011**	**1,092,670**	**391,040**	**(311,537)**	**1,490,184**

Source: R&Q FY19 results

Legacy main contributor, Program Management building rapidly

Legacy was the main contributor in FY19 on the back of record purchases. Program Management's performance mainly reflected business booked in earlier periods, a function of an operation at a relatively early stage of transformational, rapid growth.

Program management is a source of annual, recurring fees, akin to global insurance brokerage, while legacy is currently a speciality, balance sheet business. As the Program Management division builds momentum it will create a solid source of high-quality, reproducible revenues to complement sizeable, but inherently more opaque deal-based legacy returns. Assuming Legacy purchases of a similar scale, Program's contribution will grow proportionately and create an intrinsically more predictable outlook.

R&Q is, however, also **progressing plans to generate fee-based revenues from legacy**, via the introduction of a service to manage purchases on behalf of third parties. Use of third-party capital will enable it to enlarge purchase scale whilst managing risks effectively.

Program Management: 147% growth in Gross Written Premium

We expect to see the full impact of program growth over the next 18 months and beyond, but the division achieved an important milestone in FY19; an Economic EBITDA of $1.8m. Especially during a period of rapid growth, R&Q regards Economic EBITDA as a better indicator (vs IFRS EBITDA) of the economic value of business already written, regardless of the length of the underlying policy period. It thus provides a more accurate reflection of the true underlying earnings power of its Program Management business.

Program Management's FY19 performance was built upon 147% growth in Gross Written Premium (GWP) to $369.3m and 148% higher Economic Commission Revenue (Commission Revenue earned on GWP). As this business is inherently scalable and requires limited capital to finance growth, a large portion of additional commissions from new business should drop to the bottom line.

The division has continued to expand in Q1 2020, with growth in existing and addition of new programs. GWP has increased to $478.4m (annualised), 30% ahead of year end 2019. The first quarter has also seen 51% growth in annualised Economic Commission Revenue to $19.6m vs end 2019. The material further growth already built into forecasts is secured by contracts with existing distribution partners. These are expected to generate up to $842m of contracted premium (end 2019 figures).

We forecast another rapid increase in commission revenue this year driven by new business written in FY19, much of which will increasingly drop straight to the bottom line. The group's own target for this division is GWP of $1.5bn to $2.0bn by 2022/2023, with a c 80% pre-tax margin and to Economic EBITDA above $50m.

Expansion funding in place post equity injection in May

The group secured a US$100m equity injection (c £80.3m) in May to finance ***'significant growth opportunities'*** in both its core divisions. This cash provides considerable flexibility to move rapidly, if necessary, to take advantage of opportunities as they arise. The effective issue price for the new shares was 135p, a 7.2% discount to the closing mid-market price at the time of 145.5p share.

Outlook and COVID-19

For some entities, the pandemic has transformed FY19 results from historic to ancient history. In contrast, R&Q looks well placed, despite its own observation that the decision to shut down the world economy in Q1 2020 is likely to lead to '*one of the largest insurance loss events on record*'. We expect it to maintain growth momentum and use its recently bolstered resources **to capitalise on industry disruption**.

How has the pandemic affected the trading outlook?

Over the last three months the group has successfully implemented its business continuity plan and conducted a detailed review of the potential impact on its existing business and investment portfolio from COVID-19. That included stress tests under different scenarios which confirmed capital adequacy and its ability to continue to meet regulatory capital requirements.

The operational impact has been minimal, despite office closures across its network in accordance with government guidelines. Its staff and systems have adapted to remote working with no significant degrade to operations and performance.

It has, however, identified some limited impacts which include potential delays in completion of new legacy deals, and slower growth in program premiums on the back of lower economic and business activity. It nonetheless still has an existing strong pipeline of opportunities in both Program Management and Legacy, which early indications suggest will be enhanced by the 'hard market' created by the pandemic.

It consequently does not believe that the COVID-19 pandemic has shifted its fundamental growth prospects or strategy, despite the severe impact on global economies and insurers.

We continue to forecast a rapid rise in premiums and commissions this year, predicated on business written during 2019. Additionally, R&Q's existing legacy books contain limited exposure to unexpired risks and are thus protected against the likelihood of significant future claims. These forecasts are further underpinned by the scale of insurance risk underwritten and insurance class diversification.

Limited anticipated impact on investment portfolios/returns

The investment portfolio is **defensively positioned**, with 92% of invested assets currently rated BBB or better. That limited the impact of market volatility and R&Q reported just a 1.2% unrealised loss on the investment portfolio across the first four months of FY20. That was an £8.2m loss (£13.4m unrealised losses net of £5.2m realised gains and income).

Investment allocation

£'000s	2018	2019
Government/gov. agencies	63,228	188,030
Corporate bonds	202,424	345,296
Equities	24,369	10,991
Cash based investment funds	105,397	15,646
Cash and cash equivalents	236,923	252,741
	632,341	**812,704**

Source: Company

Competitive advantages, significant for both divisions

R&Q will look to capitalise upon opportunities from the pandemic's impact on the wider insurance industry. It expects this to accelerate growth already achieved by its specialist operations and **its proactive approach to accessing the 'hard market'** in its two business lines prompted its decision in May 2020 to raise $100m of new capital.

Its competitive positioning is derived from high barriers to entry for new program managers i.e. at least an A- rating, strong capital base, licenses covering key territories in the US, UK and Europe and the ability to execute with both MGA and reinsurance partners. It currently identifies limited direct competition for Accredited in its program space, with few well capitalised and suitably rated program managers in its key markets.

It expects Program Management to be able to forge new origination partnerships as existing insurance capacity struggles to continue to provide capital support. It order to capitalise upon opportunities in the current market, it has brought forward its entry into the US Excess & Surplus (E&S) Lines Program Management segment, a large addressable market in which it does not presently compete.

R&Q's platform breadth also gives it **material competitive advantages** in the legacy market. Clients can access a full range of solutions via rated and fully licensed carriers in the US, UK and Europe, a Class 3 Bermudian reinsurer, a Bermudian segregated accounts company, a Lloyd's platform and consolidation vehicles in Guernsey, Isle of Man and Vermont.

Position at year end 2019

£'000s	UK	North America	Europe	Total
Gross assets	460,617	1,153,071	478,722	2,092,410
Intercompany eliminations	(128,640)	(132,124)	(50,773)	(311,537)
Segment assets	331,977	1,020,947	427,949	1,780,873
Gross liabilities	293,176	1,097,367	411,178	1,801,721
Intercompany eliminations	(55,826)	(250,150)	(5,561)	(311,537)
Segment liabilities	237,350	847,217	405,617	1,490,184
Revs. from external customers	84,860	101,989	16,450	203,299

Source: R&Q FY19 results

It recently broadened that platform via the launch of National Legacy Insurance Company in Oklahoma. That enables it to benefit from the Insurance Business Transfer (IBT) legislation recently enacted in that state, akin to the UK's Part VII transfer process in which it has considerable experience. It is currently preparing its first application for an IBT into NLIC. This business comes from the Excess Casualty Reinsurance Association (ECRA) pool ($1.4bn of gross liabilities) it manages exclusively on behalf of Pool Members.

Legacy is already seeing more opportunities from insurance companies seeking to free-up capital by divesting insurance reserves. The pandemic has arguably enhanced the appeal of its proposition to insurance entities, as the latter seek ways to address an urgent need to diversify their revenue streams and/or release capital.

Accredited's experience and reputation for robust due diligence and oversight makes it a suitable partner for MGAs and reinsurers.

Valuation: NAV/share discount vs peers & 6.0% yield

The equity valuation is best judged as a sum of the parts, as R&Q's two divisions have distinct revenue models and earnings profiles. We have set out below a range of KPIs typically used to assess equity valuations for each operation to provide the context for an appropriate NAV multiple for the combined business.

Combined Group: 1.18x NAV vs 1.99x industry average

Net asset value per share

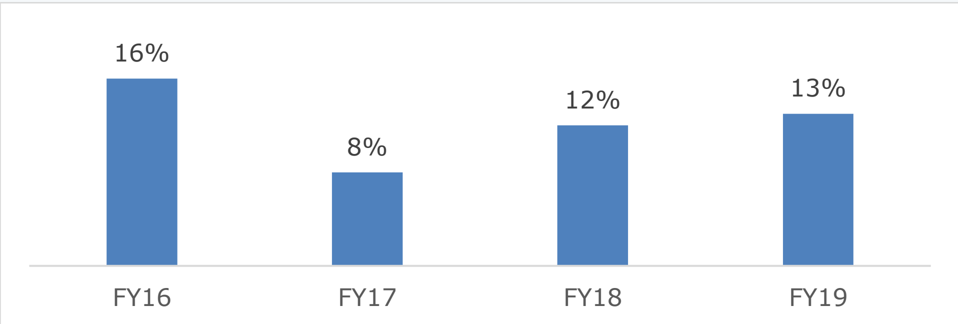
	2018	2019	2020 *
Net assets at 31 Dec (£000)	175,638	290,246	370,546
Shares in issue at 31 Dec, m	125.984	195.918	260.608
Net asset value/ordinary share	139.4p	148.1p	142.2p

*Source: R&Q FY19 results, * 2020 is proforma i.e. FY19 NAV/share adjusted for recent equity issue*

R&Q's current rating at 1.18x NAV is below the average for industry peers. We do not believe that that discount is justified by Program Management's relatively early stage growth, or the combined group's underlying performance, as both divisions have produced higher growth and net returns relative to the average for their direct comparable over the last three years.

On a combined basis, that has been reflected in growth in underlying NAV/share.

Absolute change in NAV/share including distributions



Source: R&Q FY19 results presentation

Program Management

The metrics for Program Management pivot, in line with insurance brokers, on growth in recurring annual fees, high pre-tax margin, and scalability.

Valuation is typically based upon a multiple of KPIs such as revenue/EBITDA growth, adjusted for EBITDA margin. Recent divisional performance provides strong underpinning for that argument, and its rating and comprehensive fully licensed coverage of its key markets, points to potential scale at a multiple of current levels.

Over the past five-years, publicly traded insurance brokers have traded at 3.6x LTM Revenue and 16.4x LTM EBITDA. Over the last three financial years, R&Q's Program Management division has generated a 280% CAGR (FY17-FY19) in commission revenue vs quoted insurance broker average of 8% (peer group of Marsh & McLennan, Willis Towers Watson, Arthur J. Gallagher, Brown & Brown and AON).

R&Q's **Program Management** operation is at relative early stage vs its more established 'peer group'. However, this is in our view fully offset by its growth potential, competitive positioning, scalable infrastructure, and the rapidly building PM book, reflected in the group's assessment of 'Economic EBITDA' i.e. actual operating earnings based upon business already booked. That points to a material increase in operational scale over the next few years.

This is a proven busines which has already captured some of the potential, although the nature of underlying cashflows and revenue recognition means that this is yet to be reflected in full year revenue/EBITDA.

Legacy

A similar case can be made for the group's **Legacy** operation. Its comparative would be speciality insurers, particularly as it has generated the kind of consistent annual returns that belies the inherently transactional, one-off nature of its business. This division's 5-year **Operating RoAE is 20.2% vs the 9.4% average** for Specialty Insurance companies.

Legacy businesses are assessed as on the scale and stability of their returns on capital and underlying and potential growth in book value. With respect to the latter, indicative valuations of speciality insurers over the last 5-years, are 1.99x NAV, well above the equivalent multiple for R&Q.

Group value

That still suggests some material undervaluation vs R&Q's projected growth and internal targets, which are a multiple of current levels.

Distributions: share based, one for 22, equivalent to 9.9p/share

The group dividend will be paid in ordinary shares at a rate of 1 share for 22 held, equivalent to 9.9p/share (FY18: 9.2p). The scrip dividend reflects the wider macro environment and regulatory pressure, but the intention is to restore the cash distribution for future payments.

Expanded Management team

Since the start of 2020 R&Q has announced senior management appointments as part of its succession planning. In January, **William Spiegel** joined as Executive Director and Deputy Group Chairman. He will assume the position of Executive Group Chairman when R&Q co-founder, Ken Randall, steps down towards the end of the current year. Mr Spiegel will be based in R&Q's New York office and focus on strategic development and expansion.

Tom Solomon's appointment as Executive Director and Chief Financial Officer was announced in May. Mr Solomon was Managing Director and Head of Americas Insurance Investment Banking at Bank of America. He has previously held senior positions at Citigroup and PricewaterhouseCoopers, LLP. He will also be based in R&Q's New York office and report to William Spiegel.

Eamonn Flanagan joined as an independent non-executive director with effect from 1 June 2020. His career in London's insurance industry dates from 1984, initially at Royal Insurance where he qualified as an actuary, then as director and head of European insurance at a leading investment bank. Mr Flanagan co-founded Shore Capital Markets.

Divisional Performances

Legacy: record year

Legacy acquisitions have been a core R&Q activity for almost 30 years. Over the last decade it has completed 102 transactions in 18 countries and acquired £620m of reserves.

The Legacy operation generated a 19.6% operating return on capital in FY19; the average for the last three years is 17.6%. Operating ROC is R&Q's preferred metric to assess the profitability and value of its legacy business. It measures profit on new deals, reserve changes from prior years deals and investment income (excluding unrealised gains or losses) associated with its total legacy portfolio.

FY19 was its busiest year yet. It completed 16 transactions and assumed £276.2m of net reserves, with deals secured in several US states, Bermuda, Barbados, Ireland, UK & Sweden. The table below sets out the largest of these deals. This included the acquisition of Global Re, the largest undertaken by R&Q to date. Global Re is a New York domiciled carrier which has been in run-off since 2002.

£'000s	Intangible assets	Other receivables	Cash & Investments	Other payables	Technical provisions	Tax & deferred tax	Net assets acquired	Consideration	Gross Deal Contribution
NNIS	-	787	3,233	(156)	(13)	-	**3,851**	3,071	**780**
WCIC	-	822	3,235	(32)	(790)	-	**3,235**	2,278	**957**
Presidio	100	-	1,112	-	(1,030)	-	**182**	-	**182**
LTT	15	-	764	-	(474)	(5)	**300**	-	**300**
Global Holdings	20,997	4,776	150,669	(1,838)	(66,187)	(1,300)	**107,117**	62,422	**44,695**
Sandell Holdings	7,585	34,155	61,878	(8,309)	(55,203)	-	**40,106**	20,251	**19,855**
Churchill	732	-	6,628	-	(6,085)	-	**1,275**	-	**1,275**
Blossom	-	-	257	-	(87)	-	**170**	-	**170**
Lansen	-	-	383	-	-	-	**383**	-	**383**
Distinguished Re	1,908	-	15,297	(38)	(14,049)	-	**3,118**	383	**2,735**
	31,337	**40,540**	**243,456**	**(10,373)**	**(143,918)**	**(1,305)**	**159,737**	**88,405**	**71,332**

Source: Company, ED

Legacy deals are difficult to forecast, with no material information ahead of time regarding their timing, scale, or potential returns. R&Q however reports a 'very healthy' pipeline and further increases in deal size in line with its increased scale and existing platform breadth.

It also sees potential for significant opportunities to flow from the current global Covid-19 crisis. The impetus will include companies which seek to make more efficient use of capital by disposing of their legacy liabilities. For example, these could include a commercial carrier or syndicate suffering from investment losses or unexpected claims development, a cash-strapped industrial or commercial business owners with trapped capital in its 'captive' insurance subsidiary.

R&Q expects Legacy to continue to generate strong, consistent Operating Return on Capital over the next few years and intends to supplement returns with a recurring fee income stream, derived from legacy business managed on behalf of third parties. It reports growing demand from alternative capital providers such as pension/sovereign wealth funds and family offices for access to its legacy insurance business. These bodies are attracted by potential for diversification, as insurance liabilities are generally non-correlated with other securities.

Program Management: building scale, business lines and reach

Program Management is a highly scalable, primarily fee-based business. The division has achieved rapid growth since its launch from two MGA partnerships at end 2016, to over 30 in seven countries currently. R&Q expects to add programs in four more countries this year.

In additional to new partnerships it has also expanded the number of business lines covered; from two in 2016, to currently 17 different classes of non-life Property & Casualty business in the US, UK, and Europe. It expects to add further business classes this year and has established a 'Brexit solution' via the creation of a UK branch of its Malta program insurer.

R&Q plans to further build this business by incorporating an additional strand this year, its proposed launch of a US E&S Lines Program Management business. This will complete Accredited's strategic initiative to become a comprehensive program management solutions provider across its major global markets.

Market opportunity remains significant, despite recent growth

R&Q's estimate the US, UK, and European MGA/broker market at **over $100bn of annual premiums** and in each jurisdiction the independent MGA channel, as a means of insurance distribution, is still growing. There are multiple explanations.

- Insurance product distribution is becoming increasingly specialised
- Underwriters have been leaving insurance companies to own their own "non-regulated" independent business
- The *InsurTech* boom has created new tech-enabled distribution companies

Although the MGA/broker market is not entirely addressable by the program management market, the independent MGA channel continues to grow as a proportion of the total market. Independent MGAs seek to establish stable insurance company relationships and can achieve that by working with a program manager. That partnership means independent MGAs can retain more control over their future growth.

As an example, Lloyd's decision to stop underwriting certain classes of business prompted underwriters to leave to join existing MGAs or start new ones. Another major trend driving demand for program managers is the reduction in premiums for reinsurers on large programs, which are increasingly being retained by primary insurers. A partnership with a program manager allows a reinsurer to access premium directly and maintain a source of premium growth.

Summary Financials & Forecasts				
Y/E Dec 31, £m	**2017**	**2018**	**2019**	**2020e**
Net Premiums Earned	168.7	63.4	174.5	250.0
Investment and other income	16.3	17.4	28.8	15.8
Total income	**185.0**	**80.8**	**203.3**	**265.8**
Gain/(loss) Net insurance claims incurred	(109.0)	10.7	(143.2)	(144.0)
Operating expenses	(84.4)	(77.3)	(78.7)	(90.0)
Adj. operating profit*	(8.4)	14.2	(18.5)	31.8
Other - neg. goodwill/amort. & impairment of intangibles	22.8	4.4	68.2	15.0
Operating result	**14.3**	**18.6**	**49.7**	**46.8**
Interest (net)	(4.2)	(4.3)	(9.5)	(9.5)
Share of loss of associate	-0.3	0	0	0
Pre-tax profit from continuing operations	**9.8**	**14.3**	**40.1**	**37.2**
Income tax (charge)/credits	(0.3)	(3.9)	(1.3)	(1.2)
Profit after tax - continuing operations	9.5	10.3	38.8	36.1
Profit from discontinued operations	13.5	(2.5)	0.0	0.0
	23.0	7.8	38.8	36.1
EPS - continuing operations (basic) p	10.5	7.8	21.4	16.6

Source: R&Q historic, ED analyst forecasts
**Operating result before goodwill on bargain purchase and intangibles impairment*

Investor Access

Hannah Crowe
Direct: 0207 065 2692
Tel: 0207 065 2690
hannah@equitydevelopment.co.uk

Equity Development Limited is regulated by the Financial Conduct Authority

More information is available on our website

www.equitydevelopment.co.uk

Equity Development, 15 Eldon Street, London, EC2M 7LD. Contact: info@equitydevelopment.co.uk 0207 065 2690