R&Q Insurance Holdings

A flying start to ’23 with new JV and Portfolio wins

1 February 2023

R&Q recently announced the first acquisition by its new joint venture with OBRA Capital. OBRA, which recently changed its name from Vida Capital, holds a 9% stake in R&Q. With this transaction, R&Q taps into a potentially new distribution channel represented by an emerging trend identified by insurance industry research.

This trend sees large industrial (non-insurance) groups increasingly seek ways to achieve finality in respect of their long-tail liabilities. These relate to worker compensation claims for exposure to asbestos, silica, foam etc. According to PWC’s Global Insurance Run-Off Survey (2022), the size of these corporate liabilities globally is estimated at US$68bn. This equates to an enormous pipeline of potential deals, of which only a modest number have been completed so far.

Many industrial companies have so far covered these liabilities on a ‘self-insured’ basis and set aside substantial cash to cover estimated future claims. As their exposures have evolved and matured, a number have chosen to separate these liabilities into a subsidiary, provide sufficient assets to cover the exposure, and then look to sell the subsidiary to the legacy industry.

Although these are non-insurance liabilities are unregulated, they still require **liability management expertise** such as R&Q provides. Its skills include how to manage exposure, deal with claimants etc.

New string to R&Q’s bow

As well as the JV’s operational benefits and a useful combination of a specialist asset manager (OBRA) with a liability and claims manager (R&Q), the transaction reflects the commitment to further partnership. This adds important perspective for any investors with concerns regarding OBRA’s large shareholding and, we believe, illustrates an intention to continue to work closely with the group in the future. OBRA acquired its stake in R&Q via a collateral call on Brickell, which reduced Brickell’s ownership by ~50%.

The transaction **increases R&Q’s reserves and non-insurance liabilities under management (RUM) to over US$1bn**, which now comprises traditional insurance reserves (Gibson Re) and non-insurance legacy liabilities. The group has provided legacy insurance solutions to insurers, reinsurers, and corporate captives for decades. This transaction is a new potential growth area as it provides similar services for non-insurance, corporate liabilities.

Program Management update confirms momentum

In December 2022, R&Q Accredited approved partnerships with **seven new programs** which will begin writing business over the course of Q1 23. Anticipated total Gross Written Premium (GWP) is c US$130m over next 12-15 months. These included new programs and the expansion of existing partnerships for Accredited America and a new program partnership for Accredited Europe with its first MGA partner in Germany.

Shares well below our Fair Value

We have adjusted long-term forecasts to reflect the above, but not any potential adverse development on retained legacy reserves in FY 2022. Nor have we yet assessed the impact of moving to US GAAP in FY 2023, beyond replacing day-one gains with reserve releases. Clearly R&Q experienced some extraordinary events during 2022 which could also impact results near term. Nonetheless, we believe investors should be encouraged by operational progress which also supports our move away from a sum-of-the-parts valuation to an earnings multiple / dividend yield basis.

Our Fair Value per share now stands at 155p.

Company Data

EPIC	RQIH
Price (last close)	75p
52 weeks Hi/Lo	178p / 55p
Market cap	£283m
ED Fair Value / share	155p

Share Price, p

Source: ADVFN

Description

R&Q Insurance Holdings Ltd. Is a long-established UK and US insurance business, led by experienced management.

It is focused on two core strategies:

Program Management is a fully regulated commission fee-based business, which acts as a conduit between reinsurers and MGAs (insurance distributors).

Legacy Insurance provides exit solutions for legacy/run-off insurance assets to vendors in the US, Europe, and Bermuda.

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Program Management division

A speculative discussion in Q4 2022 should be put in context. This suggested that Tradesman Program Managers had, unexpectedly, moved much of its program management services to another fronting carrier. This affected c $200m of GWP and c $10m of fee income starting in 2023.

R&Q owns 40% of Tradesman, so this would have been a mutually agreed decision. Such a move should be viewed as R&Q's continued focus on risk management, ensuring that no MGA or reinsurer is too large. Although a reduction in Tradesman GWP affects group GWP growth for 2023, we don't anticipate any material change in our Program Management GWP forecast.

We have therefore adjusted our underlying fee income projections in line with this**. Program Management is primarily a fee income business** and earns c. 5% on GWP which is primarily ceded to third party reinsurers. R&Q retains c. 7% of premium driven primarily out of Europe and, as it only receives fee income on c 93% of GWP ceded to third party reinsurers, we have adjusted our fee income expectations to reflect this more accurately.

For H1'22, R&Q had an underwriting loss of c. US$2m (US$4m annualised). This was associated with adverse development in UK motor and the purchase of reinsurance to protect the group balance sheet for this retention risk. We now anticipate underwriting income will break even during FY 2023 post rate increases and stabilisation of the reinsurance market. We have also increased fixed operating expenses to reflect inflation from FY 2023 onwards.

R&Q is due to release its full Q4 Program Update in February and we intend to comment in more detail post that release.

Legacy Insurance division

Industry coverage of the legacy insurance market has noted a progressively more competitive trading environment over the past five years, particularly as meaningful capital has entered the sector.

Although R&Q has acquired on average over ~US$500m of reserves in each of the past few years, 2022 is likely to have been materially below that and that is certainly in part due to timing. At the end of H1 2022 it announced that it had executed two transactions with US$5m of reserves and in December 2022, a loss portfolio transfer with US$60m of reserves. As a result, we estimate that FY22 year-end RUM, which represents the 80% ceded to Gibson Re, will be c. US$425m. That suggests that FY22 fee income will be below H1 2022 annualised, and day one gains on the 20% retained will be minimal.

However, we consider this as characteristic of the discipline necessary to operate profitably in this market.

Moreover, R&Q's new non-insurance legacy liability transaction with its JV partner, OBRA, creates a new distribution channel. Its first transaction, the acquisition of MSA Safety referred to above was announced in early January 2023, but the preparation would have been completed during 2022. **R&Q has confirmed that RUM is now above US$1bn, which suggests that FY22 RUM below forecast does indeed seem to be a timing issue.**

The interims included a c. US$3m underwriting loss associated with adverse development and we would expect inflation to remain a material overhang on the reserve adequacy of the broader insurance market. Legacy insurance reserve reviews generally take place in Q4 and in common with other insurers, R&Q may report an increase in reserves directly due to inflation upon conclusion of its actuarial analysis. Our FY 2022 forecasts do not, however, reflect any potential adverse development beyond that reported YTD Q2 2022. As the group moves to US GAAP for 2023, we assume that c. US$14m of annual reserve releases will replace day-one gains on the 20% of retained transactions for the period based on ~10% margin on acquired net reserves.

Based on US$1bn of RUM from the start of 2023, including the JV transaction (at a lower fee margin than the 4.25% fee earned from Gibson Re), we have not meaningfully changed our FY23 forecasts for RUM or fee income. Our estimates assume that Gibson Re is fully deployed by end of 2024. If deal origination was below expectations, then both fee income and reserve releases would be lower.

Higher interest rates

Higher interest rates will continue to affect the market value of fixed income securities and the resulting unrealised investment losses accounted for in earnings. We don't however regard such losses as economic. The group's investment portfolio is high quality, with a duration lower than its liabilities and the exposure is focused on fairly stable casualty - rather than volatile and sizeable property catastrophe claims.

The rising interest rate environment should conversely enable allow R&Q to reinvest in investment grade assets at attractive market yields and we have reflected that benefit in our forecasts. Conversely, as R&Q's debt is mostly floating, we have also increased forecast interest expense to reflect this.

First transaction for JV: MSA Safety Inc.

The JV purchased a subsidiary of global safety equipment manufacturer MSA Safety Inc. which held MSA's legacy product liability claims for coal dust, asbestos, silica, and other exposures. MSA injected US$341m of cash plus related insurance assets into this entity, and the JV another US$35m on a 51:49 basis with R&Q being the minority investor.

That US$17.5m is R&Q's maximum respective exposure irrespective. MSA has removed all related product liability reserves, related insurance assets, and associated deferred tax assets of the divested subsidiary from its balance sheet.

The JV acquired and will professionally manage these legacy liabilities. It provided MSA Safety with a complete finality solution. It is precisely the kind of **capital-efficient, fee earning transaction** which fits R&Q's strategy for its legacy operation. It is however distinct from the type of legacy insurance reserves previously secured and hence it will not be ceded to Gibson Re as it concerns non-insurance liabilities. As a result of this transaction, R&Q will see its RUM increase to over US$1bn, comprising two pools: traditional insurance reserves via Gibson Re, and non-insurance legacy liabilities.

Additionally, the JV structure and related exposures limit counterparty credit risk to the capital invested. This means that although average fees earned will be lower than for the regulated deals ceded to Gibson Re, they will nonetheless cover the capital invested over a two-to-three years period post purchase. Unlike regulated legacy assets, there is no obligation on the group to inject additional money if there is a shortfall.

Valuation

As noted, our Fair Value per share is now 155p. That reflects the impact of a more competitive operating environment, but also the resilient performances and prospects for both divisions, the inherent potential of which we believe is broadly intact and, in some respects such as the new JV, arguably enhanced.

That fair value equates to a PER below 10x our estimated adjusted underlying FY24 EPS of 16p, based on an adjusted FY24 group pre-tax operating profit of $80m.

Summary Financials

Indicative projections				
12 months to end December ($m)	**FY21**	**FY22e**	**FY23e**	**FY24e**
Program Management				
Gross Written Premium (GWP)	1,033	1,750	2,250	2,750
Fee Income	45	82	105	128
Tradesman RQIH share	11	11	11	11
Underwriting Income	0	(4)	0	0
Gross Operating Income	56	89	116	139
Fixed Operating Expenses	(35)	(35)	(36)	(37)
Pre-Tax Operating Profit	**21**	**54**	**80**	**102**
Margin	36%	61%	69%	73%
Legacy Insurance				
Reserves/Exposures Under Management (RUM)	417	425	1,500	1,750
Fee Income	0	13	36	51
Underwriting Income	59	(3)	14	14
Investment Income	19	19	29	33
Gross Operating Income	78	29	79	98
Fixed Operating Expenses	(84)	(80)	(80)	(80)
Pre-Tax Operating Profit	**(6)**	**(51)**	**(1)**	**18**
Margin	NA	NA	NA	18%
Group				
Corporate / Other	(35)	(39)	(40)	(40)
Total Pre-Tax Operating Profit	**(20)**	**(36)**	**39**	**80**

Source: Equity Development projections, Company historic data

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