Randall & Quilter

Transforming revenue visibility

10 September 2021

R&Q's latest transaction, the creation of Gibson Re as a 'sidecar' for future legacy deals should progressively smooth contributions from the Legacy Insurance division and create a new, equally substantial but far more visible, source of profitable revenue.

R&Q referred to planned sidecar creation previously and the structure will reduce opportunities for earnings surprises caused by unpredictable legacy deal timings. As its portfolio scales, Gibson Re should help transform R&Q's Legacy division from an entity that reports substantial but unpredictable, episodic upfront profits on acquisitions, into an asset manager earning fee income from legacy insurance portfolios assembled on behalf of third parties. On all new deals, R&Q will only retain a 20% participation onto its own balance sheet.

Formation of Gibson Re

The new sidecar provides R&Q with access to a substantial capital base, initially US$300m, but potential future sidecars will be raised when that pool is committed. It will reduce the need for future equity issues to support growth from its own balance sheet and progressively release R&Q's own capital for reinvestment elsewhere and support a progressive distribution strategy.

The net impact is likely to be an even FY21e result, as 80% of upfront profit from legacy purchases will now belong to the sidecar. However, Gibson Re will pay R&Q a 4.25% pa fee of all reserves acquired for at least the next six years and based on current demand for its services and a continuing strong legacy deal pipeline (currently estimated at c US$1bn of reserves) project revenues from FY22e onwards should be **both substantial and much more visible.**

Interims: Program Management growing rapidly

The interims reveal acceleration in underlying Program Management division growth. It is rapidly attaining scale, reporting an **eleven-fold increase in pre-tax operating profit at a 40% margin**, both annualised. The $23.5m headline group H1 21 pre-tax operating loss demonstrates how legacy deal timing can materially impact reported numbers; two deals signed in H1 due to complete in H2 would have seen R&Q achieve breakeven. Historically, c 70% of legacy transactions by reserves happen in H2. The new structure will remove seasonality and significantly reduce the importance of deal timing.

The 2p interim dividend and progressive distribution strategy underpin our 3.1% FY22e yield. **Our unchanged 240p / share fair value** assumption reflects trading post period end, and outlook for higher quality revenue from the new structured Legacy division. That will move the rating from a sum of the parts for two distinct businesses: **PM** (fee business) on an earnings multiple and **Legacy** (M&A related) a multiple of Tangible NAV, to an EBIT multiple for both as Gibson Re's book scales up.

Summary forecasts (US$ unless specified)			
Year end 31 Dec	**2020A**	**2021E**	**2022E**
PM Fee Income (incl. minority stake)	22.0	55.0	96.0
Legacy Underwriting Income	103.0	60.0	15.0
Legacy Fee Income (Gibson Re)	0.0	5.0	26.0
Pre-Tax Op. Profit	20.6	20.5	35.0
EPS (c)	14.2	(0.5)	1.0
Yield on distribution (%)	2.4	2.8	3.1
Tangible NAV per share (c)	173	170	180

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

Company Data

EPIC	RQIH
Price (last close)	170p
52 weeks Hi/Lo	194p/153p
Market cap	£467m
ED Fair Value/share	240p

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.

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Sidecar transforms future revenue profile

The formation of Gibson Re should complete another strand of R&Q's core strategy, to transform both divisions into substantial and high-quality sources of visible revenues.

It transforms its Legacy Insurance business from a balance sheet intensive entity with episodic earnings, into a more capital light operation with predictable, largely recurring fee-based revenues. That will scale up over the next 18 months, subject to receipt of the necessary regulatory approvals.

Although the transaction will reduce reported FY22e profits, R&Q's decision is to trade substantial but opaque legacy insurance purchase profits, into more predictable, asset management style fee income. That will reduce use of group capital (and the prospect of future equity issues) and shift the load to a new $300m Bermuda-domiciled collateralised reinsurer, owned and funded by sophisticated insurance investors.

R&Q summed up the 'before and after' scenario as below. In essence, it reduces complexity, uncertainty and volatility of revenues, and the need for further capital to support growth.

Old, complicated Framework	New, simplified Framework
Complex revenue model, driven by upfront Underwriting Income associated with Legacy Insurance	Clear revenue model, driven by annual recurring Fee Income of Program Management GWP and Legacy Insurance reserves
Episodic earnings due to unknown timing of Legacy Insurance transactions	Predictable and high-quality annual Fee Income
Balance sheet intensive due to required capital for Legacy Insurance transactions	Balance sheet lighter, with capital required to fund growth provided by third parties

Source: R&Q interim results presentation

Interim results

The interims reflect exactly the episodic nature of a Legacy operation which R&Q seeks to address via Gibson Re. The US$23.5m pre-tax operating loss was timing related; two Legacy Insurance transactions signed and expected to close in H2 would have moved the group towards broad break even.

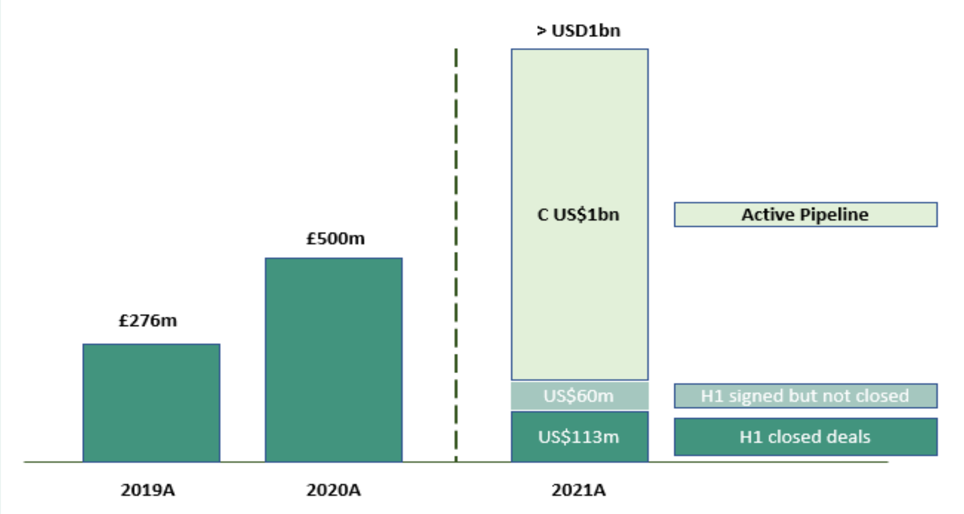
Typically, some 70% of the group's legacy transactions have completed in the second half of its financial year.

Interim results (US$m except where noted)		
Income Statement	**H1 2021**	**H1 2020**
Pre-tax operating profit	(23.5)	12.8
Operating EPS (c)	(8.5)	5.9
Profit before tax	(45.4)	0.7
Reported EPS (c)	(13.7)	0.5
Fiscal Year dividend/share (p)	2.0	3.8
Balance Sheet	**30 Jun 2021**	**31 Dec 2020**
Tangible NAV	**439.4**	**474.9**
Tangible NAV per share (c)	**160.2**	**173.3**
Net Asset Value/share (c)	**180.8**	**193.3**

Source: R&Q interim results

The figures confirm a **strong pipeline of legacy deals and a helpful market cycle** which should continue to underpin growth within the new entity. Legacy completed eight transactions and ended the period with a transaction pipeline equivalent to over $1bn of reserves. It also completed the first Insurance Business Transfer in Oklahoma between two unaffiliated parties, a potential new opportunity for its US legacy operation.,

Legacy Division - Net Reserves Acquired



Source: Company, ED

Once Gibson Re's initial deals are in place revenues which were predominantly booked as each transaction closed will be smoothed out across a typical seven-year life of a legacy post acquisition. We assume that R&Q will maintain its strong profile in the market for smaller to medium size legacy acquisitions.

Program Management: stand-out H1 21 performance

The Program Management division added eight new programs in July and August which grew contracted premium to c $1.8bn.

On an annualised basis the division reported $890m of GWP and $50m of fee income, respective y-o-y growth of 80% and 135%. Also on an annualised basis, divisional pre-tax operating profit based on H1 21 was $20m vs $1.6m half last year, at a 40% margin vs 7.5%.

R&Q has increased its FY23 GWP target from US$1.5bn to $1.75bn.

Segment Financials

US$m	Program Management	Legacy Insurance	Corporate / Other	Total
H1 2021				
Pre-Tax Operating Profit	9.9	(14.8)	(18.6)	(23.5)
Unearned Program Fee Revenue	(5.5)	0.0	0.0	(5.5)
Net Intangibles	0.0	(3.3)	0.0	(3.3)
Non-core & Exceptional Items	0.0	0.0	(6.6)	(6.6)
Net Unrealised & Realised Gains/(Losses)	(0.7)	(4.5)	(1.3)	(6.5)
Profit Before Tax	**3.7**	**(22.6)**	**(26.5)**	**(45.4)**
H1 2020				
Pre-Tax Operating Profit	0.8[2]	37.5	(25.4)	12.8
Unearned Program Fee Revenue	(2.5)	0.0	0.0	(2.5)
Net Intangibles	0.0	(1.7)	0.0	(1.7)
Non-core & Exceptional Items	0.0	0.0	(1.8)	(1.8)
Net Unrealised & Realised Gains/(Losses)	(0.1)	(8.6)	2.5	(6.2)
Profit Before Tax	**(1.8)**	**27.2**	**(24.7)**	**0.7**

Source: Company

This transaction builds strategic momentum

R&Q's core focus is to increase fee income and the creation of Gibson Re is a direct fit with that strategy.

It previously referred to a strategy to establish 'sidecar deals' and progressively reposition the division as an asset manager for Legacy Insurance business. This should enable it to focus on its core strengths, which comprise insurance origination, underwriting and claims management.

Under the terms of the transaction, over the next three years Gibson Re will reinsure 80% of all of R&Q's qualifying Legacy Insurance transactions. The new entity's capital will allow it to acquire c US$2bn of insurance reserves. R&Q will receive an annual fee of 4.25% on reserves ceded to Gibson Re, plus potential performance fees. R&Q will manage Gibson Re for a minimum of six years. After seven years it will offer a commutation of the outstanding reserves.

The composition of the group's portfolio, now comprised of three income generating businesses (excluding investment income), is set out below.

Legacy Insurance	Program Management	MGA Investments
Launch of Legacy Ins. Asset Management business	Increased 2023 GWP target to US1.75bn from US$1.5bn. Program Fees are c 5%	40% ownership of Tradesman Program Managers
Formation of Gibson Re, raised c US$300m of long-dated capital; supports US$2bn of reserves	68 programs (end Aug 21)	Tradesman net income US$31m (H1 21 annualised)
Annual recurring Fee Income of 4.25% of ceded reserves for at least six years, plus potential performance fees	Gross Written Premium US$890m (H1 21 annualised)	Contributes fee income of US$12m (H1 21 annualised) to Program Management
Potential to launch additional AM vehicles when Gibson Re capital is fully utilised	Annual recurring Fee Income of US$50m (H1 21 annualised)	

Source: Company, ED

Legacy Division: outlook transformed by Gibson Re

The formation of Gibson Re simplifies the Legacy Insurance revenue model. It replaces lumpy underwriting income and inherent seasonality (typically 30:70 H1/H2 of acquired reserves) into a more predictable, high-quality recurring fee income model.

To put this in context, recurring Fee Income in FY20 would have increased from 17% to 52% of gross operating income via the implementation of Gibson Re

R&Q will now redirect all of its legacy operations into Gibson Re and utilise a c US$300m capital base, sufficient to support legacy acquisitions with cumulatively around $2bn of reserves. To ensure that interests are aligned, Gibson Re will reinsure 80% all new qualifying legacy transactions – probably from 1 October – for the next three years and R&Q will retain the other 20%.

Although the disappearance of 80% of upfront profits on legacy purchases will affect the next 18 months' results as the new business ramps up, it will be more than compensated, on current projections, by a recurring annual fee equivalent to 4.25% of Gibson Re's reserves for at least six years, plus potential performance fees.

On current projections, if Gibson Re's capital is fully deployed by 2023 the Legacy division's fee income run rates will be **c US$50m pa**. R&Q will potentially raise a new sidecar after three years to access additional capital to support Legacy Insurance business growth.

Forecasts and valuation

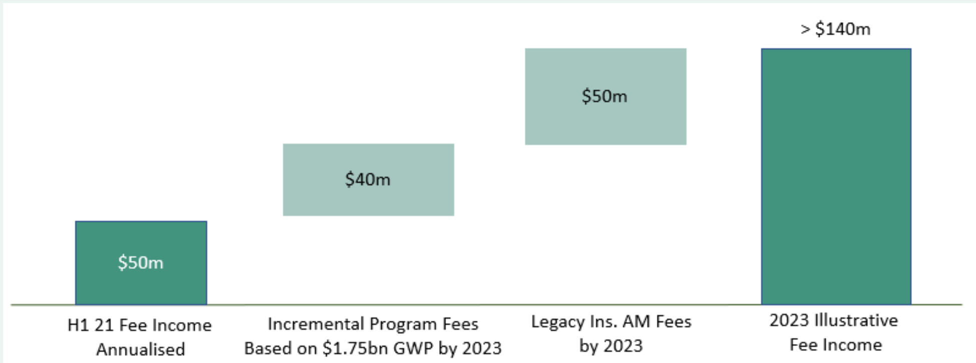
R&Q has switched to reporting figures to US$ from GBP in line with its underlying revenues. It maintained a strong capital and liquidity position and a period end solvency ratio of c 171% (vs target minimum 150%) and adjusted debt to capital ratio of 29% (target maximum 30%).

The group declared a 2p per share interim dividend and it anticipates that, in line with its progressive dividend policy, the FY21 dividend will be above the 4p paid in FY20.

The creation of a fee-based legacy business model will affect reported earnings. In essence, the difference is in the timing of revenue recognition as upfront capital-intensive underwriting Income is replaced by predictable annual recurring fee income. The formation of Gibson Re means that FY 2021 pre-tax operating profit will be broadly in line with FY20, dependent upon timing of the completion of Legacy Insurance acquisitions.

By 2023 however, R&Q's targets put it on track to generate run-rate fee income above U$140m pa and pre-tax operating profit of over $90 million, assuming Gibson Re capital is fully utilised.

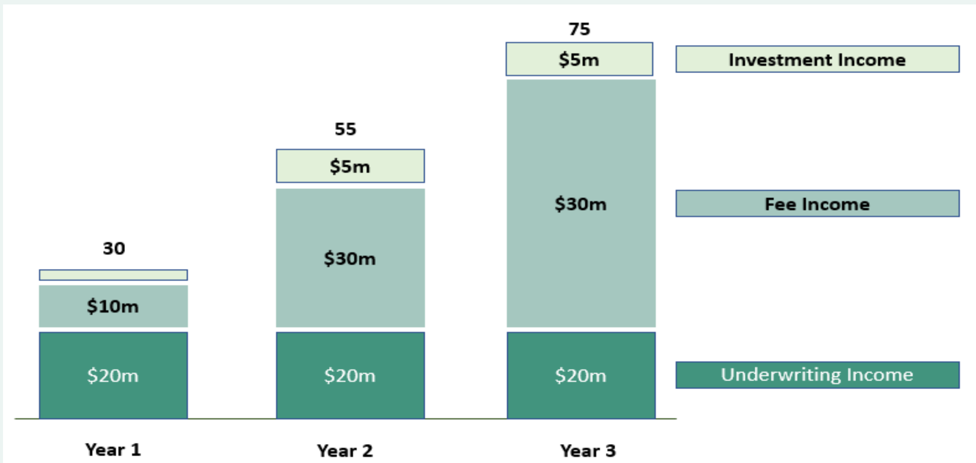
Future Fee Income Outlook – three fold increase by 2023e



Source: R&Q interim results presentation
Assumes Program Fees of 5% of ceded GPW; 90% of $1.75b GPW is ceded and 10% is retained
2.Run-rate Fee Income assuming Gibson Re capital is fully utilised by 2023

Qualifying transactions include all R&Q Legacy Insurance transactions based on the division's current underwriting and investment guidelines. Gibson Re will pay R&Q an annual fee equivalent to 4.25% of ceded reserves, plus potential performance fees and the scale of the potential returns from the first three full years of this new operation are reflected in the chart below.

Legacy Division - Net Reserves Acquired



Source: R&Q interim results presentation

These are based upon the c US$300m from equity and debt investors raised by Gibson Ltd. R&Q will not own any securities of Gibson Ltd and can call the capital at any time during a 3-year underwriting period. It also reflects the fact that the financials are shared via an 80/20 between Gibson Re and R&Q which will align interests.

Gibson Re will pay its share of transaction and operating expenses and the agreement includes the provision, from seven years after the closing date, for R&Q to provide a commutation of outstanding claim reserves.

Valuation: unjustified discount to industry peers

R&Q is a market leader in its specialised insurance markets, benefitting from strong competitive positioning and favourable market conditions.

It looks ideally placed to benefit from secular trends as a key provider of capital management solutions to insurance industry. PWC's Run-Off Surveys point to over US$860bn of global legacy liabilities and demand for R&Q's services is reflected in its strong pipeline. Key drivers include under-performing business lines, higher regulatory capital requirements, including Solvency II and prevailing low interest rates, all of which put pressure on owners of legacy assets to seek solutions which free up capital for alternative uses.

The group reiterated its progressive dividend, and expectation that the FY21 distribution will be above the 4p per share paid in FY20. The dividend pay-out ratio for FY21 is likely to be significantly above the 25-50% target range, funded by excess capital created by Gibson Re.

The table below sets out the typical valuation multiples for listed peers for each of the group's entities. As greater clarity emerges for Legacy revenues and the rating shifts to an earnings multiple for a progressively larger proportion of group revenues, we would expect current discounts to peers shrink materially.

Breakdown of Group Valuation vs Quoted Peers

Fee Businesses		Underwriting	
Program Mgt.	**Legacy Ins. AM**	**Legacy Ins. Retained**	**Corporate/Other**
Annual Recurring Fee Income	Annual Recurring Fee Income	Underwriting and Investment Income	Corporate Expenses
Pre-tax Operating Profit	Pre-tax Operating Profit	Operating Return on Tangible Equity	Excess Capital
			Unallocated Debt
Equivalent valuation multiples for publicly listed peers			
Insurance Brokers	Asset Management	Speciality Insurers	
17.5x EBITDA	19.5x earnings	2.0x Tangible NAV	

Source: R&Q results Source: FactSet with market data as of August 30, 2021. Note that:
1.Represents median multiple for respective peer sets.
2.Brokers include Marsh & McLennan, Aon, WTW, AJ Gallagher, B&B
3.Asset managers include U.K. Alternative Asset Managers Intermediate Capital Group, John Laing Group and U.S. Diversified Asset Managers Apollo, Ares, Blackstone, Carlyle and KKR.
4.Specialty insurers include Hiscox, Beazley, Lancashire, WR Berkley, Markel, RLI, Argo, James River, Pro Assurance and Kinsale.

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