Randall & Quilter

Record first half, momentum building

21 October 2020

The interims confirmed that Covid-19 was minimally disruptive operationally in H1 20 and, ironically, may have improved both of R&Q's divisions' medium-term trading outlooks. As the pandemic and other industry events have generated significant losses for insurers, they have created the current 'hardening' market driving demand for Legacy and Program Management.

PM reported 95% higher contracted premium to US$925m at the period end; it added ten active programs and now has 36 in total. Legacy services completed nine transactions across seven jurisdictions, acquired net reserves were 81% up at £267m. The shares are yet to reflect the considerable made progress to date i.e. stand at 1.22x forecast FY20e Tangible NAV vs an average of 2.32x for Speciality Insurers over the past five years. **R&Q is growing fast, albeit at an earlier stage in its evolution - even a 25% discount to a peer group average would put the shares at c 216p.**

Interim results

The group reported a 30% increase in interim pre-tax operating profit to £10.4m. Economic commissions revenue was 88% up y-o-y at US$10.7m and there was a US$0.8m economic EBITDA gain (H119: US$0.3m loss). Legacy achieved a 17% operating return on tangible capital of (H119: 14.1%), 23.3% on tangible equity of 23.3% (H119: 16.4%), both well above 15% internal targets.

Valuation: 6.1% FY20e yield, patience to be well rewarded

R&Q has hit all key defined growth targets over the last two years and powered through pandemic-related economic and industry disruption. It reported record six-month divisional performance and, in both cases, new business pipelines, competitive positioning and the benefits of a 'hard' insurance market underpin potential to build high quality and increasingly visible revenues and grow margins in the next few years.

Underlying growth is on track for both divisions. Covid-19 only delayed approval for new Program Management (PM) deals, while subdued investment returns have since recovered. PM's financial model means that the full benefit of new programs does not hit its bottom line for six to 12 months, but results will automatically catch up with contracted revenues. **Underpinned by that kind of rapid growth outlook, we regard the shares at 11.2x FY20e EPS, with a 6.1% prospective yield and at a steep discount to listed peers, as materially undervalued.**

Summary forecasts

Year end 31 Dec	2018A	2019A	2020E	2021E
Operating Profit (EBIT) (£m)	18.6	47.6	42.0	56.0
Pre-tax (continuing) (£m)	14.3	38.1	32.8	50.0
EPS (p)	7.8	20.3	14.6	21.5
Yield on distribution (%)	5.6	5.8	6.1	6.4
Tangible NAV per share (p)	129	125	133	147

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

Company Data

EPIC	RQIH
Price	162.5p
52 weeks Hi/Lo	202p/112.5p
Market cap	£347m

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

Momentum building and returns ratcheting up

Group pre-tax operating profit was 30% ahead y-o-y in H1 20 at £10.4m. Underlying performances by both Legacy services and Program Management divisions continue to meet management's defined performance targets. The reduction in PBT to £0.6m y-o-y reflected net realised and unrealised investment losses related to the impact of Covid-19 on global markets and these have since recovered, plus the accounting effect of relatively higher reinsurance vs acquisition transactions within Legacy services.

Summary Interim results

£m	H1 2020	H1 2019	Change
Income Statement			
Pre-Tax Operating Profit	10.4	8.0	+30%
Profit Before Tax	0.6	33.1	-98%
Investment Portfolio Book Yield	1.80%	2.20%	
Total Investment Return	0.30%	2.30%	
Earnings Per Share	0.4p	19.2p	
Distributions Per Share	3.8p	3.8p	
Balance Sheet	**30 Jun 20**	**31 Dec 19**	**Change**
Cash and Investments	771.8	737	+5%
Total Equity	394.7	288.3	+37%
NAV per share	151.5p	147.2p	+3%

*Source: R&Q interims *Excludes funds withheld and of- balance sheet trusts*

R&Q has established **strong, expanding foundations** upon which to build robust income, a growing proportion of which is high-quality, contracted fee-based revenues. The bottom line doesn't yet reflect the transformational growth already achieved (see divisional results below), or the fact that this year's coronavirus-led turmoil looks to have favourably tilted the opportunity in the group's direction.

R&Q cites supportive underlying trends for both businesses which points to further cumulative growth. It invested to extend its reach during the first half, obtained regulatory approvals and licences, and added management expertise and capacity. These moves **enhance existing competitive positioning**, already well-protected by barriers to entry.

Divisional results

	H1 2020	H1 2019	Change
Program Management (US$m)			
Contracted Premium (period end)	924.9	475.2	**+95%**
Gross Written Premium	247.2	173.4	**+43%**
Economic Commission Income	10.7	5.7	**+88%**
Economic EBITDA	0.8	-0.3	
Legacy (£m)			
Net Reserves Acquired	267.3	147.5	**+81%**
Operating Return on Tangible Capital	17.7%	14.1%	**+26%**
Operating Return on Tangible Equity	23.3%	16.4%	**+42%**

*Source: R&Q interims *Excludes funds withheld and off-balance sheet trusts*

Balance Sheet: US$100m equity issue finances H1 growth

R&Q raised US$100m via new equity in H1. This bolstered the capital base and increased its solvency ratio to 191%. It ended H1 with £772m in cash and investments (FY19: £737m). NAV/share was 3% above end FY19 at 151.5p (FY19: 147.2p).

This cash supported initiatives designed to build the reach and capacity of both businesses and enhance already material competitive advantages. In H1 it established new UK and Italian branches to strengthen the PM offer, launched a US E&S carrier and secured additional licenses to write 3rd-party Legacy business in Bermuda. The cash provided further funding for Legacy transactions and R&Q also invested in a growing MGA, Tradesman Program Managers.

Further additions to executive management included a Deputy Executive Chairman, Group CFO and CEO of US Excess & Surplus Lines (E&S).

The table below shows R&Q's performance vs KPIs. These better illustrate the modest direct impact of Covid-19 and the work from home environment. R&Q reports increasing demand for its services, backed by growing recognition of its divisions as key components of the global insurance market. Legacy services has evolved into a capital management tool for large insurers, Program Management facilitates independent insurance distribution growth.

Progress vs defined Strategic goals

	Objective	Status	Outlook
Program Management	GWP of US$1.5-2.0bn by 2022/2023	US$924.9m Contracted	c US$1.1bn contracted premium post end H1 2020
	Economic EBITDA of US$50m by 2022/23	US$494.4 GWP (annualised)	Growth prospects strong, benefits of scale visible
Legacy	IRR >= 15%	16.3% five-year Op RoTC 21.4% five-year Op RoTE	Returns well above cost of capital
	Grow fee-based income	0%	Alternative capital being explored
Investments	> 60% in investment grade fixed income	97% investment grade/ money market/ bond funds	Redeploying cash in high grade investments including asset-backed securities
	No negative duration imbalance	Asset duration of c 2 years Reserve duration of c 6 years	Limiting interest rate risk
Capital and Liquidity	Adjusted debt to capital < 30%	20%	Headroom to debt/cap target provides non-dilutive financing flexibility for growth opportunities
	Group Solvency Ratio > 150%	191%	Strong solvency capital positive supported by retained earnings and equity raises
Group	Consistent distributions	Interim distribution 3.8p/share	Distribution paid every period since listing

Source: R&Q interim presentation, ED

Divisions continue to shine

Both group divisions are market leaders, benefiting from strong secular growth which is accelerating post the arrival of COVID-19. Indeed, the pandemic does not appear to have dented either operation's underlying operating performance or core outlook.

Their business platforms remain exceptionally well placed to capitalise upon growth opportunities in the current 'hard' insurance market i.e. the stage in the insurance cycle during which demand for insurance coverage outstrips supply, when premium rates can be expected to harden.

The revenue profiles are complementary. Legacy services (akin to a speciality insurer) generates high returns on capital, Program Management - which has more in common with an insurance broker - is building a base of contracted, high quality fees. Despite their attractive revenue and profit profiles, both are protected by high barriers to entry. PM's global licence and regulatory approvals, proven operational capabilities and capacity, and a strong capital base reflected in its A- A.M. Best rating.

The components of each division's performance is set out below.

Positioning and outlook

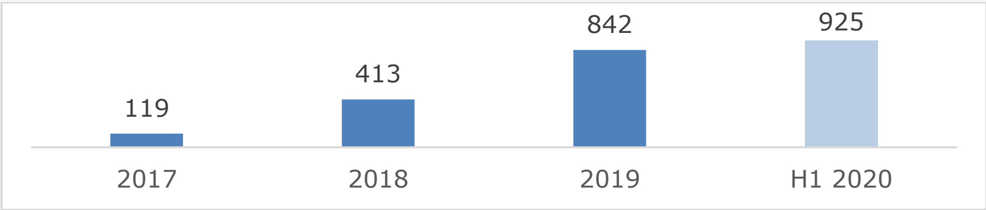
Division	Market Size	Industry Post COVID Growth Outlook	R&Q Positioning
Program Management	US$100bn of MGA/broker premium across the US, UK and Europe	Premium and commission revenue renewing at higher prices due to 'hardening' insurance market	Significant embedded growth between written and contracted premium from 40 existing MGA partners
		Growing pipeline due to reduced capital support for existing MGAs from their current capital providers	Large current pipeline of new MGAs
		Increasing demand by MGAs for US non-admitted capacity (US$55bn Excess & Surplus Lines market)	Strategic minority investments in MGAs (35% of Tradesman Program Managers)
			Entering US E&S market in Q4 2020
Legacy	US$800bn of run-off liabilities globally	COVID-19 negatively impacting reserves of certain product lines	Robust pipeline of transactions across US Lloyd's and Europe, including acquisitions and reinsurance
		Monetary policy is expected to keep interest rates low, pressuring ROEs	Pipeline opportunity to convert US$1bn R&Q managed Excess Casualty Reinsurance Association (ECRA) into legacy acquisitions
		Direct writers seek to free up capital backing run-off businesses in order to take advantage of the hard market	Exploring sidecar/ partnerships to leverage interest from 3rd party capital
		Cash strapped self-insurers need access to liquidity	

Source: R&Q interim presentation, ED

Program Management

Accredited, R&Q's Program Management division produced another period of rapid growth. It ended the period with **36** active programs and **US$925m** in contracted premium. Post the half-year end those have increased **to 40** and **US$1.18bn**, respectively.

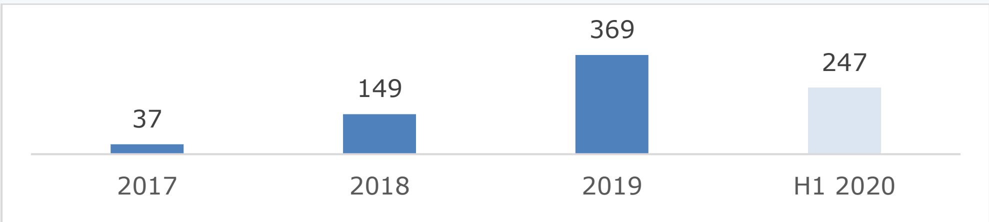
Contracted premium at period end (US$m)



Source: R&Q interim results

The PM operation generates **predictable, fee-based revenue with high margins**. R&Q receives, on average, annual recurring commissions equivalent to c 5% of gross written premium (GWP). Scale benefits are also starting to drive results; there was a positive 7.5% Economic EBITDA margin in H1 2020 vs H1 2019's loss. GWP grew 43% to US$247.2m in the first half, although there were delays in both implementing new and ramping up existing programs due to Covid-19. **R&Q sees these issues abating in H2 2020.**

Gross written premium (US$m)



Source: R&Q interim results

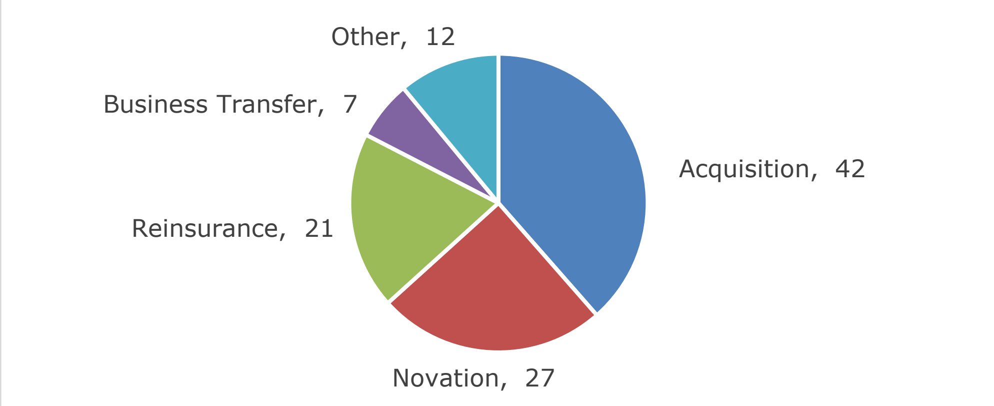
Program Management growth will come from various sources over the next few years, as shown below, with the first not requiring the the group to incur additional expenses:

- Built-in i.e. growth in existing programs as annualised GWP of US$494.4m converges with US$1.1bn of contracted premium. There will also be an increase in existing GWP, as it is re-priced upwards at renewal in the current 'hard' insurance market.
- Returns from the recently established UK branch of its Maltese carrier. This will enable it to continue to underwrite and service its UK partners post Brexit. The decision this summer to open a branch in Milan from which it can better address the needs of MGAs and other Italian clients.
- A US Excess and Surplus (E&S) Lines company set up in Q3 2020, which expands its addressable market. This is a large and growing market, which generates c US$55m of annual premium. It recently hired a new CEO, Pat Rastiello from Aon, who has directly relevant senior program experience and MGA relationships.
- Also, in Q3 2020, R&Q deepened its financial and strategic partnership with one of its fast-growing US-based MGA partners, Tradesman Program Managers LLC. This both strengthens its PM relationship and via a 35% strategic stake, adds a potentially valuable investment.

Legacy Services

R&Q's Legacy division had another strong half. It secured nine transactions in seven jurisdictions, acquired £320.3m of cash and investments and £267.3m of net reserves. Amongst the division's larger transactions in the period were reinsurance deals with Allianz, Houston International Insurance Group and Renaissance Reinsurance. The division has completed **over 100 transactions in 35 regulatory jurisdictions since 2009**.

Number of deals by type (2009 to 30 June 2020)



Source: Company

The acquisition model focuses on pricing and risk with a target return of at least 15%. In H1'20 it generated £30.2m of operating EBIT and £25.9m of pre-tax operating profit. **Those measures over the last five-years are 16.3% and 21.4%, respectively.**

This business has progressively become a component of larger insurers' capital management strategies and the current market environment is helpful. Covid-19 has combined with other insurance events to erode the capital position of many insurance market participants, which simultaneously face challenged returns from their investment portfolios. The prospect of hardening rates increases demand for legacy solutions to free up capital for insurers to redeploy. **The outlook remains positive: Legacy is traditionally more active in the second half of the year, and since the period end has signed four additional transactions for a total £8.1m of net reserves. Other deals are reported to be in the pipeline.**

Investment Portfolio

Covid-19 led financial market volatility negatively impacted the group investment portfolio despite its high quality and broadly short duration. It incurred net realised and unrealised losses of £7.1m, and the total investment return, including mark-to-market movements was 0.3%. These losses have substantially reversed themselves during H2 2020, but the overall return is lagging forecasts and is unlikely to make up the difference.

R&Q held £772m of cash and investments at the period end, excluding funds withheld and off-balance sheet trusts. This is a conservative, liquid investment portfolio structured to meet liability obligations, plus earn a reasonable risk-adjusted return. At the mid-year 94% was rated investment grade, another 3% invested in money market and bond funds that maintain high average ratings. It generated a book yield of 1.8% in H1 2020, c 0.4% below the figure for H1 2019, in line with lower interest rates globally i.e. a 0.16% two-year US Treasury yield as at 30 June 2020, vs 2.00% a year earlier.

Outlook and Valuation

Modest premium to Tangible NAV and 6.1% prospective yield

The current premium to Tangible NAV is well below the peer group average of 2.32x for Speciality Insurance companies over the past five years.

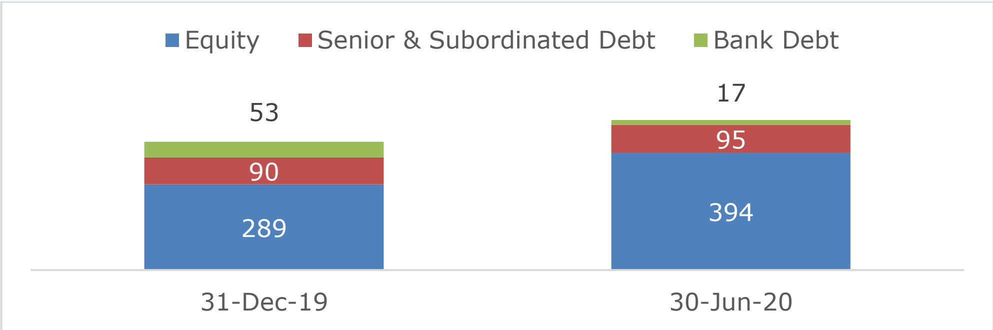
R&Q is benefiting from secular growth in its market segments. Both Program Management (+11%) and Legacy services (+8%) have grown at faster rates than the Property & Casualty (P&C) insurance industry (+4%) overall across the underwriting cycle. *(Sources: TMPAA: Program US MGA premiums (2010-2018); PwC: Legacy global market runoff liabilities (2018-2019); SNL: P&C net premiums (2010-2019)).*

Opportunity underpinned by US$100m equity issue

The capital base increased by £74m to £506m during the first half, post a US$100m equity raise during the period at 135p/share. That was a 7.2% discount to the previous close, completed during a period of Covid-19 prompted market turmoil.

The capital structure comprises equity (78%), senior and subordinated debt (19%), and bank debt (3%), with an improvement in the adjusted debt to capital ratio from 30% to 20% in H1 20.

Capital Base Structure (£m)



Source: R&Q interim results

Additionally, the **group solvency ratio increased from 177% to 191%** over the first six months to end June 2020. Stated group liquidity at the period end was £100m, including undrawn revolving credit facilities. Some of that has been used to establish its new UK and Italian branches, US Excess & Surplus lines company and to fund Legacy transactions.

Both divisions are well placed to capitalise upon the current 'hard' market conditions and secular market trends. R&Q is continuing to develop Legacy into an important partner for mainstream insurers, which capitalise upon its skills to help them find ways to adapt and evolve their owns business models in response to the challenges posed by new regulation, pandemic led economic disruption including lower interest rates.

Legacy services clients have been spurred, inter alia by higher regulatory capital charges (Solvency II, Lloyd's, etc.) which have diluted solvency ratios, pressure on returns on equity due to low interest rates, and the need to address such risks as under-reserved/volatile casualty lines and generate capital to finance M&A transactions. Its competitive positioning is derived from its ability to offer its clients a full range of solutions.

PM has rated and fully licensed carriers in the US, UK and Europe, a Lloyd's platform, and recent approvals to transact third party business in Bermuda. It looks ideally placed to capitalise upon increased demand from MGAs for reinsurance capacity, and reinsurers for strong underwriting. Higher MGA specialisation drives demand for consistent and reliable coverage from a fronting partner with no conflicts with its underlying MGA clients.

Although business already booked, supported by a strong pipeline and the 'hard' market point towards rapid growth in profit, margins and cashflows, we see potential for further fundraising over the next 12-18 months, if management decides to move opportunistically to scale up both divisions. We expect these to be incremental moves, fully in-line with defined strategy, which enhance steady and sustainable growth rates.

Outlook: building on growth already booked

To reiterate, headline numbers do not yet reflect the strength of underlying H1 20 or recent performance. Contracted PM premium, 95% up y-o-y at US$925m, is a reliable lagging indicator of future annual GWP: as GWP grows the scale benefits will be reflected in R&Q's profit margins. In additional to that delayed effect, other items obscured the H1 picture:

- A strong pipeline of new PM deals took longer than normal to bring on board. This was due to delays in receipt of approvals as regulators adjusted to remote working.
- Although Legacy services reported a record six-months, the H1 2020 business mix was skewed towards larger reinsurance deals with counterparties such as Renaissance Reinsurance, Allianz, and Houston International Insurance Group, whereas H1 19 was heavily influenced by the Global Re acquisition. That exchanged up-front profit for arguably higher quality income flows.
- Investment returns were lower than anticipated on a predominantly investment grade, short-term fixed-income portfolio. The negative market response to economic uncertainty in early 2020 resulted in £7.1m of net realised and unrealised losses in H1 20 vs £8.8m of gains in H1 19. These losses have been substantially reversed in H2, but the second half is unlikely to make up ground lost in H1.

Operational Metrics – Program Management

US$m, at period end	H1 2020	H1 2019	Change
Number of Programs	36	26	+38%
Contracted Premium	924.9	475.2	+95%
Gross Written Premium	247.2	173.4	+43%
Economic Commission Income	10.7	5.7	+88%
Economic Commission Margin	4.4%	3.3%	
Economic EBITDA	0.8	-0.3	
Economic EBITDA Margin	7.5%		

NB In H2 20 four new programs and c $195m of Contracted Premium have been added. Total contracted premium is currently $1.1bn

Source: R&Q interim results

Industry Peers – Comparative Ratings

			Market Value	Tangible NAV	Share price/ NAV	Dividend	Dividend Yield
Brokers							
Arthur J Gallaher	AJG:NYQ	$108.77	$20,826m	$ 28.66	3.8x	$ 1.80	1.65%
Aon	AON:NYQ	$212.88	$49,269m	$ 15.56	13.7x	$ 1.84	0.86%
Marsh & McLennan	MMC:NYQ	$114.94	$58,155m	$ 16.24	7.1x	$ 1.86	1.62%
Willis Towers Watson	WLTW:NSQ	$216.76	$27,932m	$ 80.27	2.7x	$ 2.72	1.25%
Speciality Insurers							
Argo	ARGO:LSE	18.50p	£7m	43.00p	0.4x	0	0.00%
Beazley	BEZ:LSE	330.40p	£2,012m	233.00p	1.4x	12.50p	3.78%
Hiscox	HSX:LSE	869.60p	£3,012m	543.00p	1.6x	0	0.00%
James River Group	JRVR:NSQ	$49.60	$1,515m	$ 18.89	2.6x	1.2	2.42%
Kinsale	KNSL:NSQ	$210.62	$4,754m	$ 20.29	10.4x	$ 0.36	0.17%
Lancashire	LRE:LSE	677.00p	£1,642m	434.00p	1.6x	11.93p	1.76%
Markel	MKL:NYQ	$971.62	$13,389m	$ 502.50	1.9x	0	0.00%
ProAssurance Corp.	PRA:NYQ	$15.08	$813m	$ 22.17	0.7x	$ 0.20	1.33%
RLI Corp	RLI:NYQ	$84.52	$3,799m	$ 22.19	3.8x	$ 0.96	1.14%
W.R. Berkeley Corp	WRB:NYQ	$62.05	$11,045m	$ 31.65	2.0x	$ 0.48	0.77%

Source: FT.com, various sites

Summary Financials

£m	2018	2019	2020e	2021e
Net Premiums Earned	63.4	174.5	647.5	757.0
Investment and other income	17.4	36.9	29.5	39.5
Total income	**80.8**	**211.4**	**677.0**	**796.5**
Gain/(loss) Net insurance claims incurred	10.7	(143.2)	(545.0)	(652.5)
Operating expenses	(77.3)	(86.8)	(115.0)	(115.0)
Adj. operating profit*	**14.2**	**(18.5)**	**17.0**	**29.0**
Other - neg. goodwill/amort. & impairment of intangibles	4.4	66.1	25.0	27.0
Operating result	**18.6**	**47.6**	**42.0**	**56.0**
Interest (net)	(4.3)	(9.5)	(10.0)	(10.0)
Share of associate profit/(loss)	0.0	0.0	0.8	4.0
Pre-tax profit from continuing operations	**14.3**	**38.1**	**32.8**	**50.0**
Income tax (charge)/credits	(3.9)	(1.3)	(1.1)	(1.7)
Profit after tax - continuing operations	10.3	36.8	31.7	48.3
Profit from discontinued operations	(2.5)	0.0	0.0	0.0
	7.8	**36.8**	**31.7**	**48.3**
EPS - continuing operations (basic) p	**7.8**	**20.3**	**14.6**	**21.5**

*Source: R&Q results, 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