Randall & Quilter

Benefitting from refocus on core operations

9 October 2018

The interims reveal the early benefits of R&Q's decision to simplify its business in 2016 and refocus on two core strategic areas. Volumes of new legacy and program management deals are gathering momentum, building complementary revenues and leveraging the group's core competitive advantages and enabling it to capitalise on industry trends. The rationalisation has created two core divisions and activities.

- **Purchase of legacy books** Acquisition/reinsurance of US and UK/EU insurance companies or policies in run-off. This activity aims to generate book value growth and progressive cash returns over on average, a one to five-year period.
- **Development of two group owned A- rated carriers.** These are licensed to provide comprehensive insurance services in the EU and US markets and will pursue strategies which generate growing, reproducible fee income.

Interims confirm stronger underlying FY18 and outlook

A strong first half saw a 40% increase in underlying operating profit (continuing operations) to £7.8m. That reflects growing contributions from legacy purchases, demand for program underwriting services in US and Europe, and a streamlined expense base. Two acquisitions announced with the interims could make a significant impact this year, subject to receipt of regulatory approval before 31 December, or in FY19 if not.

Valuation: underpinned by outlook & 4.7% prospective yield

Both divisions reported encouraging client growth and strong new business pipelines and look well placed to benefit as insurers seek to manage competitive pressures and cope with increased regulation. Additionally, R&Q's Malta base puts it in a strong position to capitalise upon uncertainty resulting from the Brexit negotiations.

Our forecasts assume the latest acquisition completes this year, but overall, builds in a 12-18 months delay before new program management business is fully reflected in the bottom line, which relates to accounting. As those factors fall away with scale, operational gearing should take over and drive up margins. Also, bigger floats and rising interest rates may see an up-tick in investment income.

A well-covered 4.7% yield (tax-free to UK private investors as a distribution of capital) and PER of 11x discounts early risks and looks attractive relative to upside potential.

Summary forecasts

Year end 31 Dec	2016A	2017A	2018E	2019E
Operating Profit (EBIT) (£m)	10.4	14.3	34.0	35.8
Adj. Pre-tax (£m)	8.5	23.5	26.0	27.8
EPS (p)	9.9	10.5	17.4	18.0
PER	19.4	18.3	11.0	10.7
Yield %	4.4	4.6	4.7	4.8
NAV/share (p)	107	121	125	130

Source: Group report & accounts and ED estimates (FY18 includes completion of Global Re acquisition)

Company Data

EPIC	AIM: RQIH
Price (last close)	192p
52 week Hi/Lo	208p / 129p
Market cap	£242m

Share Price, p

Source: ADVFN

Description

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

It is focused on two core strategies: to drive commission income from writing niche books of business using its two licensed UK and US carriers 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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Building on a transformational 2017

The FY17 statement described 2017 as a 'transformational year' which marked the start of a new phase for its business. The result for the first six months of 2018 shows momentum building.

During 2016 the group disposed of underperforming and non-strategic operations and in 2017, raised new capital to enhance the rating and profile of its subsidiary insurance entities, to leverage its infrastructure and capitalise upon significant competitive advantages.

- It has two long-established, fully licensed and now very well capitalised operations with extensive access to UK, EU and US sector and geographical insurance markets.
- Both businesses are both highly rated (A.M. Best A-), which makes them credible counterparties for target partners and clients.

Replicating that would provide a serious challenge for a new entrant and recent attempts by UK companies have proved unsuccessful.

Evolving business and financial model

R&Q's decision to rationalise its operations reflected its view of recent shifts in the dynamics and requirements of the global Property & Casualty (P&C) insurance market. It identified specific trends that it sees fuelling growing demand for legacy solutions and program underwriting management services. It has refocused on two strong growth sectors, areas where it believes that its expertise and infrastructure give it distinct competitive advantages:

Legacy Purchases & Finality Solutions	Program Management
• Acquisition and reinsurance of legacy (run-off) insurance businesses and portfolios in US and EU - 64 deals in total since 2009 • 2016: 15 deals completed • 2017: 19 deals completed • **Purchase at discount to NAV, work assets to release capital and grow book value** • Demand driven by regulation (Solvency II), US and OECD tax reforms, which may impose onerous capital and reporting obligations, pushing up compliance costs	• Develop existing group entities with infrastructure and competitive advantages • Create conduit between MGA business to highly rated reinsurers • **Build high-quality, visible revenues from commission based fee income** • Accredited (US) and R&Q Malta (EU) • Fully licenced for all territories and classes of insurance businesses • Highly rated - A- (Excellent) by AM Best

With the first phase completed we review the components of the revised strategy and potential for R&Q to reap the benefits of its recent investment.

The plan is to convert growing new business pipelines into visible, reproducible revenues, and build a profile which enables it to capitalise on demand for legacy solutions and program underwriting management services.

These two core insurance businesses generate complementary earnings sources. We believe that their competitive advantages and long-term profit potential underpin a stated commitment to growth in distributions.

Legacy Purchases and Finality Solutions

The first of two core activities is provision of customised exit and restructuring solutions for owners of discontinued or non-core insurance operations. R&Q acquires/ reinsures and manages legacy (run-off) insurance businesses and portfolios in the US and the UK/EU.

Significant track record, experience and reputation

R&Q and its predecessor companies have provided creative finality solutions to owners of run-off insurance business for over 25 years. In the early 1990s, the group's founders set up a company which successfully - over a 20-year plus period - sorted out and managed the wind-down of certain disastrously run Syndicates on behalf of the Corporation of Lloyd's.

This established the group's reputation for integrity and competence. It has also provided it with infrastructure and economies of scale which give it and a few serious competitors the specialist staff and technology which a new operation, or one managing a small number of legacy portfolios could not match cost effectively.

What drives legacy business? Who sells run-off portfolios?

Run-offs are a characteristic of long tail insurance, which requires insurers to hold substantial capital against future claims. A vendor may seek to exit a non-core or unprofitable insurance operation or reduce liabilities associated with a legacy book where it has ceased underwriting.

In other instances, an insurer may have agreed to pay an annuity to an accident victim and their dependents. That represents a financial commitment for an extended, but unspecified period. Other possible concerns include:

- A run-off portfolio will receive no further cash inflow from premiums, which makes its management more challenging than continuing businesses.
- Invested capital must be structured to ensure cash income and receipt from maturities covers claims and a provides a safety margin for unexpected variations.
- Legacy operations can be difficult to staff efficiently, as redundancies may be inevitable as insurance liabilities unwind. This does not affect R&Q post acquisition, as it will establish ongoing arrangements with staff for the next M&A deal or project.

This division's client base has broadened out from insurers with an identified need to clean up messy legacy business to include entities seeking to improve capital efficiency, reduce run-off management costs and/or the burden of increasingly onerous capital requirements. Vendors may also look to exit activities which no longer make money, free up capital to support more profitable lines of business or to reduce exposure to known risks.

EU Solvency II focused thinking on compliance and other costs

The EU's Solvency II Directive (2009) came into force in January 2016. It codified and harmonised insurance regulation and specified the capital that EU insurance companies must hold to reduce the risk of insolvency. It identified risks associated with older business and introduced an entirely new regulation, which increased capital required **by 40% on average**, to provide the necessary claims reserve. Recent US tax reforms and OECD tax policies could also impact some self-insurance entities, particularly those off-shore.

The impact of these new capital requirements has been exacerbated by the modest investment returns available in a low interest rate environment. Consequently, R&Q has seen increasing numbers of insurers seeking to dispose of their back books to run off specialists, to release capital to redeploy the into other businesses.

Range of practical solutions available

R&Q provides services to insurance companies which have stopped writing new business, and portfolios where they have ceased writing that class of business. It acquires, reinsures and manages legacy (run-off) insurance companies, including end of life captives and discontinued portfolios of business. It also provides portfolio transfers, novation or reinsurance, and can help facilitate cross-border mergers by assigning insurance liabilities and reinsuring to close open years. Benefits for current owners include:

- Relieving the burden on management to devote time to run-off
- Freeing up capital locked into the run-off for use elsewhere
- Reduced uncertainty, less potential for adverse impact on ratings and cost of capital

Profits are generated by (a) acquiring assets at a discount to NAV, (b) reinsuring purchased portfolios and (c) charging a risk premium, (d) working outstanding claims to distribute amounts below reserves. Reported returns are thus derived from capital extracted over a portfolio's remaining life and progressive improvement in book value.

Growth drivers include the potentially onerous capital and reporting obligations post introduction of the EU Solvency II regulations at the start of 2016. US tax reforms and OECD tax policies may also affect the profitability of some self-insurance entities, notably those located off-shore. R&Q also sees renewed opportunities in Lloyd's run offs and ongoing demand from insurers which have ceased underwriting. New Zealand insurer CBL and Denmark's Alpha announced decisions to stop underwriting recently.

A dedicated specialist M&A team operates streamlined process with short decision chains. It has a strong capital base and established reputation with industry regulators worldwide.

Commutation skills: key divisional USP

The group's claims management abilities have been built over the last 25-years. During that period R&Q has built an efficient claims team trained to manage run-off portfolios. One area where it is particularly strong and indeed highly regarded, is commutation. This refers to the 'early' settlement of assets/liabilities under a reinsurance policy, on terms which are normally favourable to both parties. R&Q has a reputation as an entity able to calculate a fair price for commutations.

The respective benefits are derived from:

(a) **Accounting standards.** Assets tend to be discounted for risk of non-payment and the time-delay until expected payment, but the liability is not discounted for either as it is due in its entirety.

(b) **Administrative cost savings**. Commutation removes the need for the reinsurer to maintain records and estimate liabilities under the policy, or the primary insurer to notify the reinsurer. The auditors have less work to do for either.

Any price agreed which is between the discounted value of the asset and the undiscounted value of the liability can result in benefit for both parties. In certain cases, the valuation of (i) the asset will be net of future administrative costs and (ii) the liability gross of future admin costs. As a result, the reported profits for each side can be higher.

Business gathering momentum

R&Q completed 19 legacy deals in 2017, 15 in 2016 and 64 in total since 2009. Transactions cover a broad range of solutions including (in 2017) acquisitions, novations (substitution of a new contract in place of an old one), loss portfolio transfers and two run-offs, both reinsurance to close transactions at Lloyd's.

Strong growth over the last 18 months has seen a steady flow of vendors from jurisdictions including the US, UK, Bermuda, the Cayman Islands, Ireland, Lichtenstein, Lloyd's of London, Belgium and Guernsey. The momentum has continued into 2018, with further deals in H1 and **three transactions, two particularly significant, announced since the period end.**

- R&Q's largest ever legacy reinsurance transaction providing a limit of $146m for a US based Risk Retention Group for a premium of approximately $108.5m. This deal was included in R&Q's H118 financials.
- A definitive agreement to acquire GLOBAL US Holdings the owner of GLOBAL Reinsurance Corporation of America (Global Re) from AXA for c $80.5m in cash, a small discount to net asset value. This acquisition is subject to approval from the New York Department of Financial Services. We have assumed (for our forecasts) that this will be received and the transaction completed before end FY18.
- Novation of commercial general liabilities of a Barbados based captive which reinsured the liabilities of its Canadian corporate parent into R&Q's Bermuda based segregated account. This broadens R&Q's field of activity across North America and the Caribbean. A selection of other recent legacy transactions is set out below:

Recent legacy transactions

Date	Details	Provider
Sep 2016	Transfer of business - Aegon Insurance Co. (UK) Ltd	R&Q Malta
Nov 2016	Novation from self-insurer - Maryland Motor Truck Ass.	Accredited
Dec 2016	Novation from Coca-Cola Bottlers' Association	R&Q Bermuda
Dec 2016	Acquisition: Royal London Insurance Co. Ltd	R&Q Malta
Jan 2017	Acquisition: Clariant Insurance AG	R&Q Malta
Jan 2017	Novation from PacWest Captive Insurance Co. Inc.	R&Q Bermuda
Jun 2017	Acquisition: captive insurer of a US Fortune 500 company	
Jun 2017	Acquisition of AstraZeneca Insurance Company	
Oct 2017	Agreement re run-off of Lloyd's syndicate 1110	
Jan 2018	Acquisition (£1.5m) of Constantia Insurance Company	
Mar 2018	Issuance adverse dev. re-ins for US Risk Retention Group	Accredited
Mar 2018	Assignment/assumption of liabs: two Texas self-insurers	Accredited
Mar 2018	Assignment of liabilities: large US carrier	Accredited
Jun 2018	Transaction: full finality to California based self-insurer	Accredited
Jun 2018	Re-ins agreement re legacy liabs for US Corporate airline	Accredited

Source: R&Q RNS

Program underwriting management

Program underwriting management is R&Q's second core group business. It partners managing general agents (MGAs) and their reinsurance providers and provides program capacity through its licensed platforms in the US, Bermuda and Europe.

Strategy: develop two existing R&Q entities

The strategy seeks to develop existing infrastructure to build substantial repeatable fee income from program underwriting management (fronting). R&Q's fully licenced US and European carriers selectively delegate underwriting to Managing General Agents (MGAs) with niche and profitable businesses, supported by high quality reinsurance capital providers.

It intends to develop its US admitted A- (Excellent) A.M. Best rated carrier **Accredited** into a fronting platform of choice and **R&Q Insurance Malta**, also A- rated, into a conduit for niche EU/UK MGA business to highly rated reinsurers.

These two divisional platforms are:

- **Accredited Surety & Casualty Company, Inc.** (Accredited) is a US insurer, licenced to conduct business in all fifty states and DC. It is one of very few national program managers with a T listing (US Treasury Listed to write Federal Bonds).
- **R&Q Insurance (Malta) Limited** (R&Q Malta) is licenced to write business in all 28 European Union member states.

R&Q is the only dedicated program partner which can provide A- rated capacity on both sides of the Atlantic.

A.M. Best recently increased the ratings to a higher category to reflect the enlarged capital base and confirmed their stable outlook. Ratings give partners/counter-parties confidence and enable R&Q to compete in new business lines.

Unlike some of its competitors, the group does not have any direct channel conflicts because it does not also participate in direct live underwriting. It offers its underwriting partners an exclusive service in their area of expertise.

US subsidiary: Accredited Surety & Casualty

Florida based, licensed across all 50 US states and DC

R&Q's subsidiary Accredited Surety & Casualty (Accredited) has been rated A- (Excellent) by A.M. Best for over 36 consecutive years and is T-listed (US Treasury Dept.). It is licensed in all 50 US states/DC.

Acquired by R&Q in 2014

R&Q acquired Accredited for £16m including deferred consideration in late 2014 and has since sought to expand its portfolio of insurance licences from Florida, its home state, to cover all US states and relevant categories of insurance business.

Growth since acquisition has been dramatic. Up to 2014 Accredited's business was broadly confined to insuring bail bonds against the risk of forfeiture, where it remains a market leader.

Net earned premiums (NEP) were £7m in 2015 and 2016. In 2017 it expanded into new lines of business for which it had obtained licences. Net earned premium (NEP) was £82m in 2017 vs claims of £67m. That largely reflected reinsurance of two substantial portfolios (loss portfolio transfer), supplemented by underwriting new lines.

As a nationally admitted property and casualty insurer, Accredited has a significant competitive advantage, as insurers established in one state do not automatically gain access to the US market generally. It expanded its nationwide Property & Casualty (P&C) licences in 2017 and can provide nearly every type of P&C cover on behalf of its partners.

EU subsidiary: R&Q Insurance (Malta) Limited

Licensed across all 28 EU states, unaffected by Brexit

R&Q Malta is a specialist non-life insurance company. It was founded by R&Q in 2013 as its European vehicle to consolidate run-off companies and portfolios.

It is now the group's primary risk carrier in Europe, well-placed to continue to scale up operations on the back of a strong balance sheet and licences to write business in all 28 EU member states.

R&Q Malta holds licenses for all 18 classes of business. This domicile means that the group is well placed to write business across the EU regardless of the outcome of Brexit negotiations.

Fronting service to reinsurers via an MGA network

R&Q ideally positioned to help MGAs build in the US and Europe

MGAs act as a 'fronting' system for insurers in the US and Canada, allowing filings to be made and proofs of insurance to be given in each other's jurisdictions. Accredited's comprehensive access is important, as each US State makes its own laws concerning insurance and has its own Insurance Commissioner awarding licences that are, generally, only valid in that state.

An MGA is typically an insurance agency, granted authority by a carrier to underwrite and administer insurance programs, negotiate and complete contracts on its behalf. It enables an independent underwriter to act on a delegated authority basis for a larger insurer.

Quality control is vital, as delegation to an incompetent or corrupt MGA could bankrupt an insurer. R&Q's experience, and its two subsidiaries' AM Best ratings provides comfort for the reinsurers accepting the risks.

A fronting arrangement facilitates business. This represents a convenient vehicle to underwrite business, access to reinsurers via an MGA network, underwrites live business and assumes legacy portfolios of non-life business. R&Q's subsidiaries provides a delegated authority to underwrite business which enables one insurer to use another insurer - which in the case of R&Q Malta is already licensed within the European Union - to issue insurance policies.

Typically, the fronting insurer will issue the policy to the insured, takes the business onto its books then reinsures 100% of the risk back to the original insurer, under a so-called 'fronting agreement'.

The MGA can receive applications for insurance contracts from agents and act as intermediary between carriers and agents and/or insured parties. They perform tasks normally carried out by an insurer and may be used by the latter to control costs and increase profitability, to provide a local resource able to underwrite risks, service policies and handle claims.

It can also sub-contract with independent agents for business placement, negotiate commissions, handle claims, issue policies, process endorsements, collect premiums and take responsibility to complete regulatory reports. R&Q's infrastructure help an MGA build its business. The group earns fee income and acts as partner and insurance conduit. Risk is well managed with business written mostly reinsured.

New US opportunities are attributed to market disruption and apparent retrenchment of some existing US providers.

- New Fintech/InsureTech initiatives have prompted emergence of new platforms and ways to write business. As these typically take the form of MGAs, R&Q's insurance platforms can provide the infrastructure to support these new businesses and act as a conduit between them and their (re)insurance capital.
- Brexit and uncertainty its impact on financial services is creating new opportunities for R&Q as its European insurer, R&Q Malta, is licenced to operate across the EU. **That status is not affected by the outcome of Brexit negotiations.**

Financials: interims build on strong underlying FY17

Interim results: refocus benefits continuing profits

The group reported a 40% increase in underlying operating profit (continuing operations) in the first half to £7.8m (H1 2017: £5.6m). That reflects the strategic refocus, including divestment of non-core operations, and demonstrates the operational gearing inherent in a streamlined cost base. The outlook for H2 profitability is very positive, although commission earnings from new program business will start to contribute meaningfully from 2019 onwards.

R&Q is a leaner organisation than it was 12 months ago and has redirected its resources towards two growth markets, following divestment of its non-core operations since 2016. The sale of its Lloyd's Managing Agency in November 2017 and Insurance Services division in January 2018 completed that process.

The results and more particularly, the strength of the new business pipeline illustrate how effectively R&Q has improved its competitive positioning via investment of the disposal proceeds and a c £47m equity issue in November 2017, which have strengthened the AM Best credit ratings of Accredited and Malta to A- (Excellent). The first half statement noted advanced negotiations with prospective counter-parties and an increased scale of both legacy and program underwriting transactions in its new business pipeline.

Interim results

Y/e 31 Dec, £'000s	**H1 2018**	**H1 2017**	**FY 2017**
Operating profit	7,887	7,465	27,949
PBT continuing	7,780	5,599	9,830
PBT	5,527	5,435	23,461
PAT	4,974	5,945	22,970
EPS (basic)	3.6p	7.9p	25.4p
Balance Sheet			
Total gross assets (£bn)	1.138	0.834	1.066
Cash & investments ($bn)	0.584	0.442	0.603
Total net insurance contract provisions	0.769	0.583	0.723
Shareholders' equity	0.168	0.109	0.167
Key statistics			
Investment return on free assets	0.7%	1.4%	1.6%
Return on tangible equity (annualised)	6.8%	15.4%	17.3%
Net tangible assets/share	117.6p	88.6p	105.3p
NAV/share	133.0p	124.5p	132.9p
Distribution per share	3.6p	3.5p	8.9p

Source: R&Q interims

Legacy business building momentum

R&Q completed 19 acquisitions or reinsurances in FY17. It anticipates lower transaction numbers this year, but a significant increase in average deal size. The traditional insurance market increasing regards disposal of legacy portfolios as mainstream capital management and demand for run-off solutions is growing as owners and managers of non-life insurers seek to carve out non-performing books of business and achieve greater capital efficiency.

The transactional nature of legacy acquisitions makes it difficult to predict with certainty when transactions will complete, and R&Q expressed modest frustration that acquisitions it had hoped to complete in H118 will now close in the second half. This is not however, unusual, as both the market and group results have generally reflected a second half bias.

The increased scale of new business is reflected in (a) the recently announced agreement to acquire Global Re US, its largest legacy acquisition to date, which is likely to make a material difference to results over the next 18 months, and (b) execution of the group's largest ever legacy reinsurance with a US based Risk Retention Group, which provides a limit of $146m for a premium of $108.5m.

With respect to Global Re US, the interim statement confirmed that if regulatory approval is received and the acquisition completes before the end of December 2018, FY18 profit should be substantially ahead of market expectations. We have included a contribution from Global Re in our FY18 forecasts. It also announced, again subject to regulatory approval, a smaller agreement to acquire MPS Risk Solutions Limited.

R&Q reports that it is witnessing opportunities emerging from the Lloyd's market following the Corporation of Lloyd's initiative to overhaul underperforming syndicates and lines of business. R&Q's commitment to, and long experience in managing Lloyd's run-off over almost 30-years was demonstrated by two transactions undertaken in late 2017; Sportscover and ProSight. Lloyd's legacy transactions are expected to provide a key source of business in the second half and into 2019.

It also continues to see a good flow of legacy new business opportunities outside Lloyd's being driven by onerous capital and reporting obligations for incumbent insurers, due to Europe-wide Solvency II regulations and the associated equivalence regimes. It expects to benefit from reorganisations occurring in response to recent US tax reform and OECD tax policies which could significantly impact some, especially off-shore self-insurance entities.

Program Business (Accredited)

R&Q expects to exceed its previously published minimum target of 12 new program partnerships in 2018. It reports continuing strong demand and interest in its program underwriting platforms and had entered into seven new program partnerships by end August.

These are expected to generate over $200m in annualised gross written premium (GWP) and based upon the strength of its current pipeline, R&Q expects to have secured contracts of a scale to generate GWP of approaching $500m by year-end and reports good progress towards increasing its average commission rate to 5% of GWP. It notes particularly strong progress in Europe where its European Insurance platform has entered into new partnerships with European MGAs this year, and new classes of business.

The outlook for further growth is underpinned by two highly related operations with strong credit ratings, and comprehensive licences that provide cover for all US and EU territories and insurance business classes. In the UK, its appeal is underpinned by an ability to offer a credible 'Brexit Solution' for UK insurers seeking continued access to EU insurance markets.

The program business aims to capitalise upon opportunities resulting from market turbulence. The US and Europe have seen a reduction in independent program management capacity in in 2018, and growing demand from entrepreneurial MGAs for well-rated capacity partners to act as a bridge between them and reinsurers.

Outlook: strategic refocus driving growth

Although the initial benefits of FY16's rationalisation were apparent in underlying FY17 results and the interims, we expect FY18/FY19 to provide a better illustration of the new strategy's full impact.

The group's decision to exit live underwriting is reflected in reduced losses and overheads. As the new strategy delivers, it should progressively build on the £9.8m profit generated from continuing operations in FY17 - towards £32m this year - as new programs launched over the last 12 months and recent acquisitions kick-in. **We estimate that visible, reproducible revenues from programs will add another c £15.0m to £24.0m to annualised revenues.**

Program management: Accredited drives forecast period

Despite recent acquisitions, we expect program underwriting management and particularly Accredited, to provide the main source of underlying growth over the next two years. Accredited's competitive position and appeal to MGAs is derived from the fact that its licenses cover all states and c 97% of all business classes. Much of its competition is provided by start-ups without equivalent infrastructure or Accredited's 45-year history.

R&Q expects to exceed its published minimum target of 12 new program partnerships in FY18 and by the end of August it had entered into seven new partnerships expected to generate c $200m in annualised GWP, and it anticipates that it will have secured partnerships equivalent to $500m pa by the current year end. If secured, these will contribute fully 12-18 months from completion.

Transactions have been building momentum; those completed over the last 12-15 months are set out below:

Accredited - recent Program Management transactions	
May 2017	Agreement to provide Blanket Vehicle Single Interest Insurance policy
Jun 2017	Loss Portfolio Transfer with California based insurer
Oct 2017	Agreement with Atlas General Ins. Services
Nov 2017	Agreement with Forestry Insurance Company
Dec 2017	Agreement with The Hotaling Group Inc.
Apr 2018	*Confirmation of AM Best A- (Excellent) rating*
Apr 2018	Partnership - American Team Managers
Apr 2018	Partnership - Renaissance Managing Gen. Agency
Jul 2018	Partnership - Atlas General Services Insurance LLC

Source: R&Q RNS

Program underwriting management: high quality, visible and reproducible revenues

Fee income from program underwriting management partnerships, typically commission revenues, is high quality, visible and reproducible. R&Q typically retains 5% of premiums received as an overriding commission. It has already secured a c £250m transfer book, equivalent to an annualised £12.5m income, and targets twice that by the current year-end. Its ambition is to add similar figures to its premium base in each of the next few years and reports an underlying pipeline which makes this feasible.

Binding agreements with MGAs contain two-way obligations i.e. on an MGA to show R&Q all new business and renewals, and on the group to underwrite that business. A signed contract therefore provides a level of revenue certainty, assuming renewals and new business are secured progressively. Income will build progressively as the entire book transfers over the first 12 months, much of which should be received in subsequent years as policies roll over.

From an accounting perspective there will therefore be a lag between new business and reported earnings during the first 24 months of any new program. Costs are, however, more front-end loaded, as R&Q carries out significant work to establish a new program before it starts to receive fee income.

Most of these will not contribute fully until FY19 or later, and R&Q reports an extensive pipeline of new business opportunities and plans to launch more programs this year. It anticipates 12 this year, six each in the US and Europe, vs. eight (five US, three Europe) in 2017. We estimate that will add £2.5m+ to FY18, £10-12m in FY19.

Although divisional numbers are not segmented, our analysis suggests Accredited is profitable. Divisional profit exceeded revenue from all other divisional companies combined and the 2015/2016 net claims ratio was below 1% of NEP.

Legacy: strong deal growth

The second key source of growth is an average 3.6% claims release on the group's growing run-off portfolio. This is a key area of long-term expertise and specialisation for R&Q. Significant opportunities being driven by industry consolidations, legislation (including US efforts to target offshore/Bermuda based companies) and most notably, increased regulation such as the EU Solvency II Directive.

Although the group expects to generate income over on average, the three to five years post completion of each legacy acquisition, its recent experience has demonstrated that these transactions will make a significant contribution in their first year of ownership. The group added £210m to divisional gross assets in FY17; 19 legacy deals vs 15 in FY16 (£62m net assets). Deals completed in 2017 added £57m net assets to the division at a cost of £32m (2016: £54m net assets at £38m) which compared with a total of 64 deals since 2009. These covered a broad range of exit solutions for the captive and self-insured sector. Aside from regular captive and cell structures, R&Q has completed deals with risk retention groups, self-insured funds and corporate deductible buyback programs.

Although business flows are inherently uneven, R&Q's strategy is to continue to build a market leader with the profile and scale to secure more regular transaction flows, revenues and profits, and shorten periods between deals. We outlined the two latest deals above (page 5).

The group reports further acquisitions of captive insurance companies under negotiation and a steady flow of approaches from vendors which, even if it rejected the majority as unattractive, points to more predictable revenues from this source.

New legacy purchases have been announced recently but deal flow and regulatory approvals can be uneven. We assume that the latest deals will be approved and completed before the end of the currently financial year, **which pushes up PBT to £26.0m (FY18) and £27.8m (FY19).**

Forecasts: assumptions adjusted for timing

The second six months is typically the group's stronger trading period and the H2 bias this year also will reflect the pattern of delayed commission-based earnings from the group's fast-developing program underwriting management partnerships.

R&Q's fronting business is picking up, responding to direct marketing and progressively as prospective clients are attracted by its profile and rating. It was, however, unprofitable in FY17 as commission income was relatively low. That was fully anticipated and reflected upfront costs related to establishing operations, including one-offs, and there will remain an element of front-end overheads as new business is brought on board. Our forecasts reflect those costs into account in our forecasts.

There is potential for the group to generate modestly larger contributions from external factors such as higher interest rates and currency shifts. We have assumed that these influences are neutral between now and the end of 2019.

Both divisions leveraging competitive positioning

Divisional performances will see full contributions from earlier wins and improved competitive positioning. R&Q reports higher average deal sizes which validates the strategic refocus and will benefit future years.

The full impact of growing new business volumes, including higher average deal sizes, may take two to three years to be fully reflected in margins. That's mainly due to accounting and timing issues.

- Costs of administering and implementing new program management business can involve significant upfront work, which will be expensed as incurred.
- In contrast, new programs will inevitably take time to scale up as existing policies are renewed over an initial 12-month period, and new ones sold.

R&Q has also built a pipeline of US legacy deals, but we assume that new business flows will remain uneven and timing and scale relatively difficult to predict. Subject to comment above related to regulatory approval for the acquisition of Global Re, we believe that our figures represent a cautious view of divisional revenues/profits.

For consistency we assume that legacy transactions will require regulatory approval, although that is particularly the case where they involve a change of ownership. The group will not recognise any income from these deals until it gains approval and that can take 12-15 months or more to complete. In the meantime, all costs associated acquisitions and administering new business, managing legacy portfolios and achieving approval will however be expensed.

Other timing issues will affect reported results:

- Restructuring decisions were taken in 2016 and significant reinvestment in core operations completed in 2017. However, some disposals of non-core operations were only completed last year i.e. sale of R&Q Triton in June 2017 and the group's Lloyd's Managing Agency in December 2017.
- Although restructuring costs will fall away, initial overheads incurred in implementation of new programs and acquiring legacy/run-off portfolios will have a relatively disproportionate impact on margins until they attain scale and maturity.

Assumptions: better return on invested capital, exited operations

Investment income	US 1-month LIBOR rose from 0.69% in Jan 2017 to 1.31% in Dec 2017 and is currently c 2.1%. We have assumed an increase in net interest earned on £211m of liquidity (excluding fixed interest securities not maturing before end-2018). Investment income y-o-y will benefit from (a) full year impact of £124m cash acquired with acquisitions, we estimate another £2.8m at current US 12-month LIBOR (£2.6m in FY18) and (b) £18.6m disposal proceeds received January 2018 (+ £0.3m).
Interest related adjustments	There will, conversely, be reported 'unrealised losses on investments' (fixed interest) in FY18 post rises in interest rates. Our guesstimate is a £3m negative adjustment.
One-offs	We have adjusted underlying forecasts for a £24.7m FY17 'gain on bargain purchase' (£19.9m net of expenses and goodwill impairment). Estimates for the next two years are subject to revision as R&Q reports.
Exited operations	Losses from exposure to Live Underwriting should fall from £2.8m to below £0.5m post drastic (98.7%) shrinkage of that activity. Losses from 2016 and 2017 Years of Account could grow, but not we believe materially. One retained legacy activity is a nominal participation on Syndicate 1991 for the 2018 Lloyd's year of account. Participations for 2016/2017 are expected to produce a profit for R&Q in 2018 and 2019.

Some cost escalation short term, other adjustments

Overheads	We expect operational rationalisation (including management changes) carried out in FY17 to cut c £1.5m pa from ongoing corporate costs (c £1m in FY18). We have pushed up short-term admin costs to reflect integration of acquisitions and assume this remains relatively high until R&Q shrinks the portfolio of outstanding claims, particularly as we assume low investment returns by historical standards. We have cut FY18 operational profit by £1.5m, FY19 by £2.5m, to reflect an increasing workload, as the effect of acquisitions is likely to exceed the positive impact of run-off and commutations.

Valuation: 4.7% FY'18 yield, strong profit growth

From a valuation perspective new programs and legacy transactions announced, rather than reported figures, may provide a better metric or illustration of strategic progress, as income will generally lag new business written by 12-18 months.

However, each contract should preface reliable increases in gross written/earned premiums over the following 12 months. These will cover the costs associated with bringing that business on board and should provide a guide to visible earnings.

A 4.7% prospective yield, tax free for UK private investors, discounts execution risks but full benefits of achievements so far could take c 12-18 months to be fully reflected in reported figures. That's a consequence of accounting treatment and material upfront setup costs.

We also take a cautious view of the impact of interest rate rises on a large invested capital base and forex effects, which are unpredictable. **The outcome is FY19e PER of 10.7x based upon earnings with considerable upside potential.**

Equity issues financed enhanced subsidiary capital bases in 2017

Restructuring initiatives have been accompanied by direct investment to enhance subsidiaries' profiles and competitive positioning. R&Q raised just over £66m (gross) in new equity in 2017 which it used to bolster the capital bases of its operating subsidiaries in both the EU and US, and complete other investment to support its revised strategy. That underpinned their ratings (A- excellent) and will support plans to expand operations and gross written premiums.

New capital raised in 2017

Issue Date	Raised	Details
February 2017	£17.9m gross	**Placing (117p/share)** Investment in growth opportunities
January 2017	$20m	**Issue of floating rate Subordinated Notes 2023** Raised for R&Q Re (Bermuda) Ltd to increase its Statutory Capital (Tier 2 eligible), with surplus to support growth of this core component of group's strategy. R&Q Re Bermuda is the key risk-taking entity for the group's US legacy transactions.
October 2017	£48.5m gross	**Placing and Open Offer (129p/share)** Funds increased capital bases of Accredited and R&Q Malta. The cash injection improved the A.M. Best credit ratings for both entities, which enhanced opportunities available and enabled them to secure increased commission rates. It also provided enhanced access to high quality business.

Source: R&Q RNS

A $20m Subordinated Note was issued to support the growth of R&Q Re Bermuda, a key component of its US legacy transactions business. Bermuda is a very important high-quality base for reinsurers because its tax regime does not unfairly penalise their highly erratic pattern of profits and losses. It can be regarded as high-quality, to the extent that the EU Commission accepted its standards as being equivalent to the new EU standards, albeit prior to its actual agreement on the detail of those standards.

These actions should also improve the terms of new business for each division. Management has commented that it expects its investment in 2017 to enable it to compete for and win new, more complex accounts, where commission rates are often higher.

Income statement

P&L				
Y/e 31 Dec, £m	**2016**	**2017**	**2018e**	**2019e**
Net Premiums Earned	46.1	168.7	243.0	272.0
Investment and other income	14.8	16.3	13.0	15.0
Total income	**60.9**	**185.0**	**256.0**	**287.0**
Gain/(loss) Net insurance claims incurred	(12.0)	(109.0)	(146.0)	(170.0)
Operating expenses	(56.1)	(84.4)	(95.0)	(100.0)
Adj. operating profit*	**(7.2)**	**(8.4)**	**15.0**	**17.0**
Other - neg. goodwill/amort. & impairment of intangibles	15.5	22.8	19.0	18.8
Operating result	**8.3**	**14.3**	**34.0**	**35.8**
Interest (net)	(1.9)	(4.2)	(8.0)	(8.0)
Share of loss of associate	(0.0)	(0.3)	0.0	0.0
Pre-tax profit from continuing operations	**6.4**	**9.8**	**26.0**	**27.8**
Income tax (charge)/credits	0.7	(0.3)	(4.0)	(5.0)
Profit after tax - continuing operations	**7.0**	**9.5**	**22.0**	**22.8**
Profit from discontinued operations	1.3	13.5	(2.0)	0.0
	8.3	**23.0**	**20.0**	**22.8**
Distribution per share p	8.6	8.9	9.1	9.3
EPS - continuing operations (basic) p	9.9	10.5	17.4	18.0

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

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