# Randall & Quilter

## Capitalising on opportunity

10 May 2019

**We expect patient investors to be well rewarded as the full benefits of R&Q's investment in its two core divisions become visible over the next 18-24 months.**

### FY18: continuing pre-tax profit £14.3m, +45%

**Underlying FY18 results confirm operational progress in line with strategic targets. Investment to date has established two high potential operations.**

The first, Programme Management (PM) continued to grow organically. Its prospects were buoyed by an upgrade in its A.M. Best rating, a US$70m bond issue in December and a £103.5m equity issue post the year-end. The high rating is key to attracting enquiries from prospective new PM partners. The second division, Legacy/run-off secured further acquisitions in FY19. These included Global Re, its largest legacy deal to date, which received regulatory approval post the year-end.

### Complementary revenue streams

The group's two divisions' have distinct earnings patterns. PM builds gradually, but new operations incur expenses upfront as they build books of high quality, reproducible earnings. We don't expect divisional growth to add materially to pre-tax profit this year. Legacy purchases can be difficult to forecast, particularly timing, but in contrast to PM can contribute to profit on day-one under group ownership. R&Q seeks to buy run-off insurance assets at a discount to book value, book an initial profit, then work acquired portfolios to release revenues over an extended period.

Further scale advantages are derived from returns from a substantial investment portfolio and its access to a single support staff/infrastructure. **The shares are on undemanding ratings that appear to ignore clear growth opportunities.**

### Outlook: attractive yield, building high-quality earnings base

We expect both divisions to achieve target scale in 2020 and fully contribute from FY21. Our forecast includes a substantial initial contribution from Global Re this year, then progressive growth from PM from FY20. R&Q reports a strong pipeline of PM enquiries and potential legacy acquisitions, and complementary revenues should create a stable revenue base and support a progressive distribution. The latter is paid from capital, so the 5.0% prospective yield is tax-free to UK private investors. NAV forecasts reflect a £103.5m equity issue post the year-end and retained earnings, net of dividends.

**Summary forecasts**

| Year end 31 Dec | 2017A | 2018A | 2019E | 2020E |
|---|---|---|---|---|
| Operating Profit (EBIT) (£m) | 14.3 | 18.6 | 50.0 | 50.0 |
| Pre-tax (continuing) (£m) | 9.8 | 14.3 | 40.0 | 40.0 |
| EPS (p) | 10.5 | 7.8 | 17.8 | 16.7 |
| Yield % | 4.7 | 4.8 | 5.0 | 5.1 |
| NAV/share (p) | 133 | 139 | 172 | 189 |

*Source: Group report & accounts and ED estimates*

**Company Data**

| | |
|---|---|
| EPIC | RQIH |
| Price | 190p |
| 52 week Hi/Lo | 208p/157p |
| Market cap | £374m |

**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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## Operational growth on track

**FY18 results were broadly on track as R&Q continued to roll out new program management operations, adjusted for delayed recognition of legacy acquisitions. It agreed to pay $80m for Global Re in autumn 2018, but as regulatory approval was received later than anticipated that will now be reflected in FY19, not FY18. Operating profit from continuing operations was £14.3m, 45% ahead of 2017.**

**Group Performance**

| 12 months to 31 Dec, £'000s | 2017 | 2018 |
|---|---|---|
| **Income statement** | | |
| Operating profit - continuing | 14,318 | 18,596 |
| Pre-tax profit - continuing | 9,830 | 14,251 |
| Profit before tax | 23,461 | 11,693 |
| Profit after tax | 22,970 | 7,822 |
| Earnings per share (basic), p | 25.4 | 5.8 |
| **Balance sheet** | | |
| **Total assets** | **1,065,791** | **1,197,573** |
| Cash and investments | 602,753 | 638,672 |
| Total insurance claims gross reserves | 722,535 | 699,078 |
| Amounts owed to credit institutions | 55,889 | 140,243 |
| Shareholders' equity | 166,772 | 175,638 |
| **Key statistics** | | |
| Investment return on invested assets | 1.60% | 1.20% |
| Return on tangible equity | 17.30% | 5.00% |
| NTA per share, p | 105.3 | 123.6 |
| Book value per share excl. goodwill, p | 120.8 | 139.4 |

*Source: R&Q results*

The FY18 result was also net of a £2.9m shortfall in anticipated investment returns, post turbulent global investment markets at end FY18. R&Q has confirmed that that negative has been more than offset by stronger investment performance in the early part of FY19.

## Divisional review and outlook

R&Q is something of a work-in-progress as it builds two divisions, program management organically, legacy acquisition activities via acquisition, both in fast-growth markets.

Both operations are well positioned but at relatively early stages of scale up, and we don't expect either to make full contributions in the remainder of 2019 or probably 2020.

The deferred nature of PM commissions earnings means that the full benefit of growth from contracted business will be reflected over the following 18 to 24 months. Commissions will accumulate and operational costs be absorbed quickly to reveal a high margin business.

Program management operates via R&Q's Accredited subsidiary and generates fees through licensed and rated platforms in the US and Europe. It acts as a conduit for capital providers, typically well-rated reinsurers, and niche underwriting businesses, predominantly MGAs.

# Financials

R&Q continued its ongoing transformation into a more focused business in 2018. It expanded its resources to support further expansion in line with this strategy, issuing a US$70m bond and raising £103.5m via new equity issued earlier this year. FY18 headline numbers also include substantial, but gradually declining contributions from exited operations due to unwind over the next 18 months.

## Balance sheet underpinned by fundraisings

Two events over the last five months, a bond issue towards the end of FY18 and an equity raise post the year-end, have materially strengthened the balance sheet and provide resources to finance the growth strategy. These coincided with an upgrade to group/subsidiary A.M. Best ratings.

## Bond issue secured $70m in December 2018

In December 2018, R&Q raised $70m via an issue of 10-year senior subordinated loan notes at a margin of 6.35 per cent over USD 3-month LIBOR. This new debt funding expands R&Q's capital base and will support operational growth. It and forms part of the group's long-term financing strategy alongside the equity issue below.

## Placing and Open Offer raised £103.5m in February 2019

In March 2019, post the year-end, R&Q raised c £103.5m net via a placing and open offer at 153p per share. That was a discount of approx. 15% to the closing price on 6 February 2019, the day before the issue was announced. The equity issued (65.34m new shares) represented c 52% of the group's issued ordinary share capital of R&Q prior to the placing.

The estimated impact on the group balance sheet is set out below.

**Proforma Balance Sheet**

| £m | 2018 Actual | Impact of new capital | Global assets/ liabilities | Consideration for Global Re | Proforma Balance Sheet |
|---|---|---|---|---|---|
| Total assets | 1,197.6 | 103.5 | 156.9 | (61.9) | 1,396.1 |
| Total liabilities | (1,021.6) | | (95.0) | | (1,116.6) |
| **Total equity** | **176.0** | **103.5** | **61.9** | **(61.9)** | **279.5** |

*Source: R&Q statements The above table sets out the FY18 reported balance sheet, adjusted for an equity issue in March 2019 and the Global Re acquisition*

## Proceeds support core growth strategy

The proceeds, net of c £3m of fees and expenses will be used to:

- Support continued development of the program management business
- Maintain the AM Best credit ratings of the Accredited entities
- Pursue identified legacy opportunities
- Replenish liquidity used for previous acquisitions
- Re-balance the funding mix post the $70m bond issue

## Operational review

We expect R&Q to secure further material growth in both core divisions by the end of 2020, building complementary revenue streams, while margins will continue to improve as a result of scale benefits and streamlining.

### Program Management

**Accredited, R&Q's PM business in the US and Europe should benefit from (a) recent upgrades in the AM Best rating and (b) Brexit, however messy, as its Malta domicile enables it to provide solutions to issues generated from any scenario.**

R&Q's competitive advantages are derived from its comprehensive licences, strong credit ratings and in Europe, its ability to provide a credible 'Brexit Solution' for UK insurers, which seek continued access to EU insurance markets. Recent upheavals in the Lloyd's market add further opportunities and momentum.

The division entered into 12 new program partnerships across the US, Bermuda, European and UK markets last year and by end FY18 had secured contracts with MGAs expected to generate annualised written premiums of $500m. We expect it to take c 18 months before that growth is fully reflected in Group figures. We anticipate further growth over the next few years, with a potential US$0.6bn to US$1.0bn accessible based upon the current growth strategy, licensed market reach and capital base.

| Program Management | | |
|---|---|---|
| **Live Division - results (£000s)** | **2017** | **2018** |
| Result of operating activities | (5,565) | (3,802) |
| Program Management Result | (2,240) | (2,759) |
| MGAs' result | (501) | (731) |
| Live Syndicates result* | (2,824) | (312) |
| *Participation on Syndicate 1991 ceased after the 2017 YOA and is now in natural run off | | |

*Source: Company*

Program Management's earnings pattern means that it can take 18-24 months for growth in contracted premiums to be fully reflected in results, as recognition of commission earnings from new PM business is typically deferred over the two years following commencement of each program. That was reflected in the operating result for FY18. Losses (primarily upfront set up costs) will decline and margins build rapidly as the division builds its book of premiums underwritten, and R&Q will progressively receive full commissions.

A strong rating is also key. Accredited reported greater interest from prospective business partners regarding underwriting partnerships in the US, post an upgrade in its rating (from VI to VII) in 2018. Higher demand reflects the appeal of a high quality, fully licenced operation with an A.M. Best A- rating.

Counterparties often require a minimum group rating, particularly in program underwriting partnerships. Accredited's financial strength ratings represent an indication of balance sheet strength and its ability to stand behind its commitments. The A.M. Best ratings of the group's relevant subsidiaries have either been affirmed or upgraded post the end of FY18.

## A.M. Best rating upgrades since year end

| | |
|---|---|
| **Feb 2019** | **Accredited Surety and Casualty Company Inc. (ASC) and Accredited Insurance (Europe) Limited (AIEL)** |
| | A.M. Best affirmed Financial Strength Ratings of A- (Excellent) and Long-Term Issuer Credit Ratings at "a -" for these wholly owned R&&Q entities. |
| | ASC is a Florida based US insurance company licenced to write admitted P&C business in all fifty states and DC and is an ISO and AAIS subscriber. It partners with MGAs and similar companies and their insurance capital partners to write business on ASC licensed and admitted paper. |
| | AIEL is a Malta based European insurance co. licensed to write all non-life classes in all EU member states and provides a distribution channel for reinsurers. It can provide a ready-made Brexit solution to European MGAs. |
| **Mar 2019** | **Increase in A.M. Best rating for ASC** |
| | The A.M. Best Group rating for Accredited Surety & Casualty Company, Inc. was increased from VII to VII. This reflected balance sheet strength, both for Accredited and the R&G group. |

*Source: Company*

## Legacy/run-offs: more opaque, high potential

The group intends to scale up legacy acquisitions and reports an encouraging flow of larger deals, increasingly on an exclusive basis. The division completed 17 acquisitions, despite reported delays in securing other deals that it may well announce this year.

**The Global Re transaction, announced in September and completed in April 2019 was the division's largest acquisition to date. The outlook is underpinned by a strong legacy pipeline that includes well-advanced new negotiations that may complete over the next few months.**

## Legacy - Divisional Results

| £'000s | 2017 | 2018 |
|---|---|---|
| Result of operating activities | 46,263 | 30,898 |
| Gains on existing portfolios (incl. commutation strategy) | 2,923 | 43,254 |
| Contribution from legacy deals | 36,914 | 9,514 |
| Investment return of free assets | 1.60% | 1.20% |

*Source: Company*

R&Q's growth strategy for the legacy division anticipates a continuing flow of new transactions. Demand has been driven by factors including regulatory changes impacting underwriters globally (Solvency II, recent US tax reforms and certain OECD tax policies), Brexit, heightened M&A activity in the property and casualty insurance sector, and continuing separation of distribution from underwriting capital.

These factors provide momentum for the foreseeable future and should generate further attractive legacy investment opportunities.

Returns from legacy transactions are, however, inherently more difficult to forecast. The terms announced are typically quite opaque. Consideration/valuation is based upon management's assessment of independent NAV, and its projected ability to extract better than market value to secure target IRRs in an acceptable timeframe. It can take decades to fully unwind the last components of any acquired portfolio.

## R&Q well-placed to manage and unwind insurance liabilities

R&Q purchases legacy/run-off portfolios at a discount to NAV, from vendors seeking to offload legacy insurance liabilities. The acquired run-off entity typically sits outside a seller's core business and may be a run-off entity sold for a second time. Acquisition at a discount means that these transactions often contribute to profit on completion, then over time subject to R&Q's ability to achieve its projected timescale for unwinding the portfolio. A positive recent track record affirms its belief that vendors often understate potential insurance recovery.

R&Q may be better placed to assess the potential and manage the run-down of these portfolios. It has scalable infrastructure dedicated to this long-term task, will seek to integrate acquired assets, then unwind them efficiently and profitably over a period which may be short i.e. around two years or extend across decades for bigger US acquisitions. It can also use its own reserves more effectively to extract returns.

**Uncertain timing: Global Re, $80m run-off acquisition completed in H1'19**

This division has a strong new business pipeline, but completion dates may be unpredictable, particularly where acquisitions rely upon regulatory oversight or approval. That injects uncertainty into forecasts, but the fundamental investment case remains intact.

Although fewer, larger transactions should enhance synergies and net returns, it potentially makes forecasts more vulnerable to shifts in completion timing. R&Q starts work on acquired legacy portfolios when a deal is agreed, accounts for costs incurred immediately, but only recognises income upon receipt of formal approval from the regulator.

An example is the delayed completion of its acquisition of GLOBAL Reinsurance Corporation of America, the largest transaction legacy/business combination undertaken by R&Q to date. Global Re is a New York domiciled reinsurance company in run-off. R&Q paid AXA $80.5m in cash funded from available cash and debt facilities, a small discount to net assets.

R&Q waited around seven months to receive approval for change of ownership of Global Re from the New York Department of Financial Services. That pushed revenue and profit recognition back into FY19, rather than FY18 as we initially forecast based upon an expected Q4 2018 completion. The Global Re deal should materially benefit FY19 results, based on R&Q's reserve assessment and anticipated operational synergies.

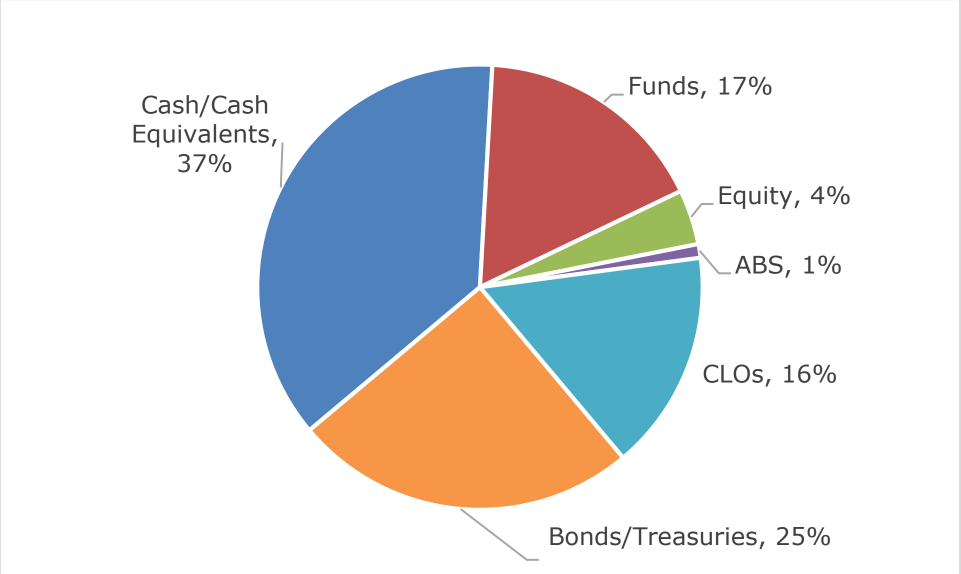
The exact timing of legacy deals is inherently difficult to predict, but R&Q's track record should provide comfort. It confirmed strong new business pipelines for both further legacy acquisitions and its US/European programme management business.

## Investment returns steady, with some upside potential

The other component of our forecasts relates to returns from the group's investment portfolio, which we expect to increase from US$630m towards c $800m upon completion of the Global Re acquisition. Asset allocations at the end of 2018 are shown below.

Returns are running at c 3-4% pa and the group regards its portfolio as well placed for the 2019 investment market outlook. It reports a strong start to the current year. Investment returns have fully compensated for losses incurred during market turbulence in Nov/Dec 2018, and performance is on track with our previous FY19 forecasts.

**Investment Portfolio asset allocation at 31 Dec, 2018**




*Source: R&Q FY19 results presentation*

## Disposals and wind-down of non-core businesses near completion

In 2017, R&Q disposed of its Lloyd's Managing Agency and withdrew capacity from 'active' Syndicate participation at Lloyd's. In 2018, it disposed of non-core insurance services and captive management operations to the Davies Group.

Since the year-end, it has exited its non-core USA Bail Bond Business and as part of the sales terms, negotiated a reinsurance to protect against adverse claims development on business underwritten up to the sale date.

Attention is now focused upon core areas to build two high-growth businesses with complementary earnings patterns. Program management should improve income visibility and help offset potential volatility related to timing of legacy earnings.

## Streamlining and simplification

The focus on the above two high growth and complementary revenue streams has been accompanied by a commitment to simplify internal corporate structures to optimise the utilisation of capital and reduce management costs.

As an acquisitive business, R&Q accumulates Legacy assets in many different entities and jurisdictions. It continued to consolidate surplus assets into three principal operating subsidiaries; Accredited Surety and Casualty Company Inc., Accredited Insurance (Europe) Limited and R&Q Re Bermuda Limited. This is an ongoing process due to the nature of the business model and regulatory requirements in multiple operating jurisdictions. It reported clear operational and financial benefits.

## Summary P&L

| Y/e Dec 31, £m | 2017 | 2018 | 2019e | 2020e |
|---|---|---|---|---|
| Net Premiums Earned | 168.7 | 63.4 | 200.0 | 250.0 |
| Investment and other income | 16.3 | 17.4 | 21.0 | 19.0 |
| **Total income** | **185.0** | **80.8** | **221.0** | **269.0** |
| Gain/(loss) Net insurance claims incurred | -109.0 | 10.7 | -110.0 | -135.0 |
| Operating expenses | -84.4 | -77.3 | -87.0 | -90.0 |
| **Adj. operating profit*** | **-8.4** | **14.2** | **24.0** | **44.0** |
| Other - neg. goodwill/amort. & impairment of intangibles | 22.8 | 4.4 | 26.0 | 6.0 |
| **Operating result** | **14.3** | **18.6** | **50.0** | **50.0** |
| Interest (net) | -4.2 | -4.3 | -10.0 | -10.0 |
| Share of loss of associate | -0.3 | 0 | 0 | 0 |
| **Pre-tax profit - continuing operations** | **9.8** | **14.3** | **40.0** | **40.0** |
| Income tax (charge)/credits | -0.3 | -3.9 | -8.0 | -8.0 |
| **Profit after tax - continuing operations** | **9.5** | **10.3** | **32.0** | **32.0** |
| Profit from discontinued operations | 13.5 | -2.5 | 0.0 | 0.0 |
| | **23.0** | **7.8** | **32.0** | **32.0** |
| EPS - continuing operations (basic) p | 10.5 | 7.8 | 17.8 | 16.7 |

*Source: R&Q, Analyst forecast   *Operating result before goodwill on bargain purchase and intangibles impairment*

# Investor Access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**Equity Development is regulated by the Financial Conduct Authority**



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