Randall & Quilter

Quality building rapidly

11 September 2019

The core strategy to build two complementary divisions and income streams looks well on track. A strong first half was driven by Legacy deals - announced in FY18, which obtained final approval in H1 - and a £16.0m boost from investment income (FY18: £5.0m). That is a reminder that Legacy transactions can be very profitable, but their timing unpredictable. We believe that makes recent rapid growth in Program Management especially important.

Contracted new Program Management business scaling rapidly

Program Management's strong recent growth has built estimated future gross written premiums to approaching $800m pa from contracts secured to date. That effectively creates high-quality regular commission income, which will attain full to speed over the next 12-18 months. That represents a steady, growing revenue base and outlook.

Interims boosted by Legacy deals completed in the period

Headline figures make good reading although specific Legacy deals are one-off boosts, so not an indication for H2. PBT was £33.1m (H1 18 continuing: £7.8m) and basic EPS 19.2p (H1 18 continuing: 3.6p). There was a 13% increase in NTA/share to 133.2p (H1 18: 117.6p) and a 12.5% return on tangible equity (H1 18: 6.8%).

We have marginally increased our FY19e forecast for better than expected investment returns, although assume an H2 contribution of c £4m. Completion of Legacy deals is also inherently tricky to predict. FY19e includes the $25m acquisition of Sandell Re, which should receive approval from the Bermuda regulator in H2. Previous acquisitions have been delayed, notably the US$80.5m Global Re deal, announced in Sep 2018, which received approval from the New York regulator in May 2019.

Further Legacy deals await approval

The Legacy division completed five new acquisitions and three reinsurances in H1. The Program Management division launched ten new contracts in the USA and Europe. Both divisions report strong new business pipelines.

The proposed interim distribution 3.8p/share (H1 2018: 3.6p) paid from capital, so tax-free to UK private investors; a prospective 5.8% yield based on 9.5p/share payment.

Summary forecasts

Year end 31 Dec	2017A	2018A	2019E	2020E
Operating Profit (EBIT) (£m)	14.3	18.6	52.0	49.0
Pre-tax (continuing) (£m)	9.8	14.3	42.0	39.0
EPS (p)	10.5	7.8	18.3	15.9
Yield %	5.4	5.5	5.7	5.9
NTA/share (p)	105	124	141	156

Source: Group report & accounts and ED estimates

Company Data

EPIC	RQIH
Price (last close)	165p
52 week Hi/Lo	207p/147p
Market cap	£325.2m

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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Patience well rewarded

There are two key underlying message from R&Q interims:

- Confirmation that pragmatic investors that who understand that the size/timing of Legacy purchases are inherently unpredictable are likely to be well rewarded. Legacy drove first half profits; further transactions have already completed or are expected to complete in H2. The transactional, one-off nature of this business limits visibility.

- Program Management growth is building a complementary, high quality, visible income stream which will typically take at least 12 months to achieve critical mass. Over the next 18-24 months however, we forecast that commission revenue from new Program Management arrangements already booked – total US$800m GWP - will grow to match the contribution from Legacy. More important, it will deliver a far more visible and predictable earnings base.

The interim result also benefited from a substantial increase in investment earnings on the group's growing insurance float. R&Q's balance sheet was strengthened considerably by an equity issue which raised £103.5m net of expenses in March 2019. The proceeds are being used to support Program Management growth and enable a focus on larger Legacy transactions.

Interim results

Despite the delay before commissions from new programs are received, pre-tax profit from continuing operations was still 325% up on H1 18. The key contribution was Legacy deals carried over from 2018; GLOBAL US Holdings and GLOBAL Re and the retro-active reinsurance of Schools Association for Excess Risk (SAFER). As mentioned above, a strong investment performance contributed £16m total income vs. £5.4m for the whole of FY18.

Group Results

£'000s	**H1 2019**	**H1 2018**	**FY 2018**
Operating profit (continuing)	37,668	10,140	18,596
Profit before tax (continuing)	33,087	7,780	14,251
Profit before tax	33,087	5,527	11,693
Profit after tax	32,600	4,974	7,822
Earnings per share (basic)	19.2p	3.6p	5.8p
Balance sheet			
Total assets	1,562,258	1,138,108	1,197,573
Cash and investments	728,915	584,163	638,672
Total gross reserves	942,250	769,059	699,078
Debt	106,614	73,223	140,243
Shareholders' equity	**302,019**	**167,940**	**175,638**
Investment return	2.3%	0.7%	1.2%
Return on tangible equity	12.5%	6.8%	5.0%
Net tangible assets per share	133.2p	117.6p	123.6p
Net asset value per share	**154.2p**	**133.0p**	**139.4p**
Distribution per share	3.8p	3.6p	9.2p

Source: R&Q interims

Divisional results

Legacy and Program Management are performing ahead of forecast, and both confirmed a strong pipeline of new opportunities. Medium term prospects are underpinned by that and both divisions' competitive positioning.

Legacy completed five acquisitions and three reinsurances in the first half and reports sight of a growing number of larger deal opportunities and continued growth in demand for Legacy solutions.

An increasing proportion of group assets and revenues are derived from non-UK based activities, which protects figures from recent sterling weakness. **R&Q has also very effectively insulated its European business from the impact of Brexit** - whatever outcome, including 'no deal' - via a structure that provides certainty regarding group access to both UK and EU customers.

In positive investment markets in the first half R&Q recovered all unrealised losses sustained towards the end of 2018. It continues to invest in high grade securities and will benefit as growth in its insurance float to £729m at the end of June 2019 (H1 2018: £584m) helps offset some of the potential impact of lower interest over the longer term.

Segmental results - H1 2019

Continuing operations, £m	Live	Legacy	Other	Consolidation adjustments	Total
Earned premiums, net of reinsurance	14.3	76.5	0.0	0.0	90.8
Net investment income	5.0	13.8	4.4	(7.1)	16.0
External income	1.6	1.0	1.8	0.0	4.4
Internal income	0.0	8.2	15.0	(23.2)	0.0
Total income	20.9	99.5	21.2	(30.3)	111.2
Claims paid, net of reinsurance	(8.7)	(21.3)	0.0	0.0	(30.0)
Net change in provision for claims	(4.2)	(44.2)	0.0	0.0	(48.4)
Net insurance claims increased	(12.9)	(65.5)	0.0	0.0	(78.5)
Operating expenses	(9.8)	(29.4)	(21.1)	23.2	(37.1)
Op. result pre.GW on bargain purchase	**(1.8)**	**4.5**	**0.1**	**(7.1)**	**(4.4)**
Goodwill on bargain purchase	0.0	42.9	0.0	0.0	42.9
Amortisation/impairment of intangibles	(0.0)	(0.8)	(0.0)	0.0	(0.8)
Result of operating activities	**(1.8)**	**46.6**	**0.0**	**(7.1)**	**37.7**
Finance costs	(0.1)	(4.5)	(7.1)	0.0	(11.7)
Pre-tax profit	**(1.9)**	**42.1**	**(7.1)**	**(7.1)**	**26.0**
Income tax (charge)/credit	(0.2)	(1.5)	1.2	0.0	(0.5)
Profit/(loss) for the period	**(2.1)**	**40.6**	**(5.9)**	**(7.1)**	**25.5**
Non-controlling interests	0.1	0.4	(0.4)	0.0	0.1
Attributable to shareholders of parent	(2.0)	41.0	(6.3)	(7.1)	25.6
Segment assets	359	1,401	152	(345)	1,562
Segment liabilities	282	918	409	(345)	1,260

Source: R&Q

Legacy: strong H1 performance and pipeline

The segmental breakdown confirmed that Legacy's contribution was the major impetus for these results. Total divisional income was £99.5m (FY18: £33.6m) and pre-tax profit £42.1m (FY18: £24.6m).

It is, however, worth noting that certain transactions, notably Global Re. were originally expected to complete in 2018. Its delay until May 2019 shifted income and profit from FY18 into H119. Timing is often delayed by rigorous regulatory scrutiny which accompanies any proposed deal.

That defines the fundamental nature of this business, characterised by relatively small numbers of potentially substantial deals. The track record suggests high certainty that an announced deal will complete but doesn't necessarily help predict timing.

Completed acquisitions performing in line with expectations

Reassuringly, R&Q confirmed that the run-off of recently acquired Legacy portfolios continued without any major surprises in the first half. The interim assessment did not indicate any significant adverse trends and it has not identified any significant reserve redundancy, which reflects the significant credit taken for reserve savings in FY18.

The division conducts lengthy, detailed pre-transaction due diligence, and annual in-depth actuarial reviews are commissioned towards the end of the financial year.

We expect Legacy to remain the major contributor to group results for the next few years. From a forecasting perspective, the inherent unpredictability and opacity of individual deals makes it difficult to build reliable projections, but R&Q has confirmed that it anticipates that it will complete further acquisitions and reinsurances in the second half year.

These include the Bermudan reinsurer, Sandell Re, which has been announced and awaits regulatory approval.

Strategy to access larger acquisitions with existing capital

The segment result also reveals the significant capital tied up in this business. That is a crucial component of the group's AM Best ratings, to reassure regulators regarding the its financial capacity to handle substantial deals.

In view of the already sizeable but potentially even larger scale of future legacy purchases, R&Q has stated that it is exploring potential 'side-car' arrangements, under which it would use third party capital to finance larger acquisitions. In these cases, the Group would take a minority share but capitalise upon its originating and structuring skills to provide 3rd party investors with direct exposure to legacy business.

Market conditions for legacy deals are positive

Owners of discontinued insurance business continue to search for efficient ways to offload Legacy portfolios, to avoid incurring onerous capital and reporting obligations. That's true even if they no longer actively participate in the business, due to European-wide Solvency II regulations and the associated "equivalence" regimes.

R&Q also expects to benefit from reorganisations in response to US tax reforms and OECD tax policies. These can significantly affect some self-insurance entities, especially those domiciled offshore.

It reported that increasing, sometimes substantial opportunities are emerging where insurers decide to sell off Legacy portfolios to free up capital to support their ongoing business. R&Q sees potential for more major mergers to trigger Legacy opportunities as part of the post-merger rationalisation process. This trend picked up momentum in 2018.

Legacy prospects

MARKET DRIVERS

- Continuing onerous capital and reporting obligations for insurers as a result of Solvency II in Europe
- Demand for run-off solutions continues to grow as owners and managers of non-life insurers seek capital efficiency
- Legacy run-off accepted as part of underwriting life cycle
- M&A activity in the P&C insurance sector incentivises companies to dispose of run-off businesses, especially in US/Bermuda
- Further fall-out from Lloyd's review of underperforming business

R&Q'S ENABLERS

- R&Q can offer widespread solutions through, among others:
  - A- VIII (Excellent) AM Best rated, fully admitted carrier licensed in 50 States & D.C.
  - A- (Excellent) AM Best rated, carrier domiciled in Malta, licensed for all classes 1-18 with freedom of services across all major EU states
- A range of onshore and offshore reinsurance facilities
- Dedicated Lloyd's run-off Syndicate
- Innovative run-off products and solutions
- Experienced and dedicated team focused on providing bespoke exit solutions within expedient execution timeframes

Source: R&Q interim presentation

Program Management (Accredited) builds momentum

Although Legacy was the major source of first half momentum, progressive growth in Program Management is building underlying quality and visibility of earnings medium term. Growth to date provides visibility for future commission earnings to balance and complement Legacy's potentially more volatile revenues.

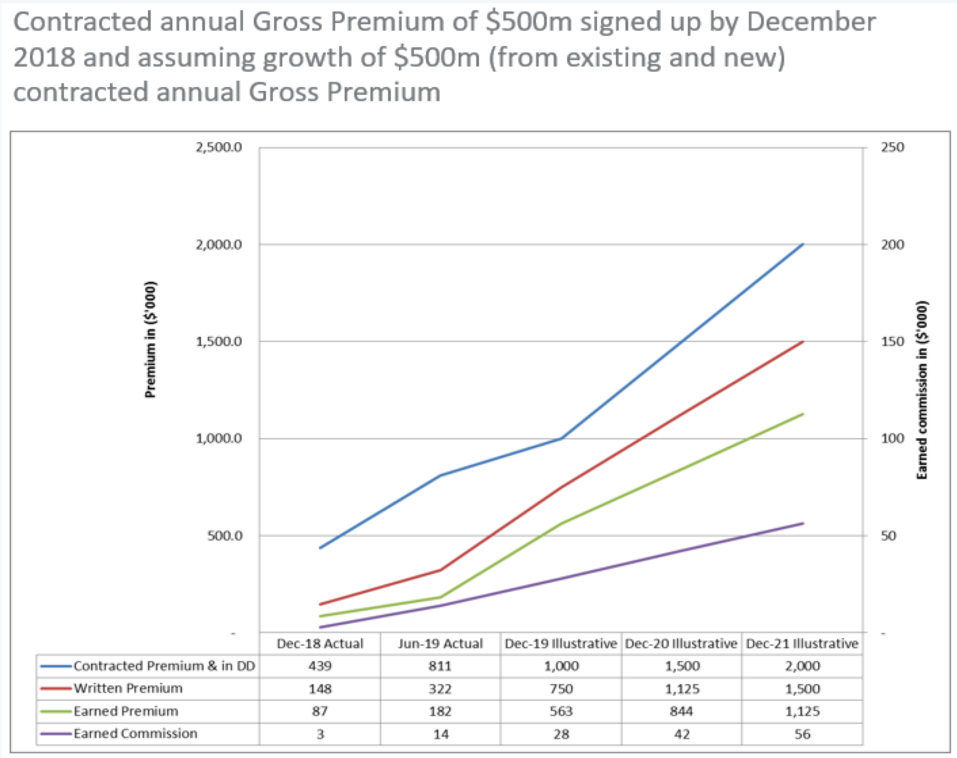
The Program Management division, Accredited, provides traditional and alternative Reinsurers with access to direct specialty insurance business and offers MGAs/Brokers greater control and alternative market capacity. It is building relationships with business producers and mainstream reinsurers. It reported that the onboarding process for newly agreed programs in Europe is a little slower than originally expected, but this segment is well on track to achieve our forecasts based upon its overall growth.

In 2018 R&Q reported that Accredited had contracted with MGAs with expected future premium income of approximately US$500m pa. That has since increased to over US$800m pa and it currently anticipates that it will move above $1bn pa during 2020.

That growth is not yet reflected in divisional results due to upfront investment in infrastructure and staff to support high growth and the inevitable deferral before the full earned commissions are visible. As a result, the division made a £1.8m pre-tax loss during the first half (FY18: £4.0m loss). It is however highly scalable and operationally geared, and on schedule to trade profitably during 2020 and build thereafter.

The charts below illustrates how commission income should grow predictably over the next few years based upon contracted Gross Written Premiums (GWP), subject to a c 12-18 months' time lag and the illustrated pattern of commission recognition.

Projected growth in commission earned



	Dec-18 Actual	Jun-19 Actual	Dec-19 Illustrative	Dec-20 Illustrative	Dec-21 Illustrative
Contracted Premium & in DD	439	811	1,000	1,500	2,000
Written Premium	148	322	750	1,125	1,500
Earned Premium	87	182	563	844	1,125
Earned Commission	3	14	28	42	56

Source: R&Q interim results presentation

Commission recognition

Recognition of commission earnings typically occurs over the two years following commencement of each program

Illustration

- Household program, £14.4m contracted on 31 December 2018 – for one year only.
- Written equally over 12 months – with effect from 1 February 2019 @ £1.2m per month.
- 5% commission = £720k.

£000's	2019											
	J	F	M	A	M	J	J	A	S	O	N	D
Written premium		1,200	1,200	1,200	1,200	1,200	1,200	1,200	1,200	1,200	1,200	1,200
Earned premium												
Jan												
Feb		100	100	100	100	100	100	100	100	100	100	100
Mar			100	100	100	100	100	100	100	100	100	100
Apr				100	100	100	100	100	100	100	100	100
May					100	100	100	100	100	100	100	100
Jun						100	100	100	100	100	100	100
Jul							100	100	100	100	100	100
Aug								100	100	100	100	100
Sep									100	100	100	100
Oct										100	100	100
Nov											100	100
Dec												100
Jan-20												
Total earned premium		100	200	300	400	500	600	700	800	900	1,000	1,100
							6,600					
Earned commission @ 5%		5	10	15	20	25	30	35	40	45	50	55
							330					

£000's	2020											
	J	F	M	A	M	J	J	A	S	O	N	D
Written premium	1,200											
Earned premium												
Jan												
Feb	100											
Mar	100	100										
Apr	100	100	100									
May	100	100	100	100								
Jun	100	100	100	100	100							
Jul	100	100	100	100	100	100						
Aug	100	100	100	100	100	100	100					
Sep	100	100	100	100	100	100	100	100				
Oct	100	100	100	100	100	100	100	100	100			
Nov	100	100	100	100	100	100	100	100	100	100		
Dec	100	100	100	100	100	100	100	100	100	100	100	
Jan-20	100	100	100	100	100	100	100	100	100	100	100	100
Total earned premium	1,200	1,100	1,000	900	800	700	600	500	400	300	200	100
							7,800					
Earned commission @ 5%	60	55	50	45	40	35	30	25	20	15	10	5
							390					

Source: R&Q interim results presentation

The approval process for new Program Management business is intensive and includes a thorough diligence review. In common with Legacy transactions, new proposals must also meet the requirements of the applicable regulatory authorities. It can take thus some months from agreeing outline terms with a new MGA until the business is launched and able to generate premium income.

Strong outlook for Accredited

Accredited recorded another period of strong new business growth in both the US and Europe. It continues to leverage its balance sheet, market knowledge and AM Best A- (Excellent) financial strength ratings, to offer a comprehensive range of insurance licenses to MGAs which seek a program partner.

Program developments

US

- 14 programs - total estimated annualised GWP US$238m, agreed and launched
- Four programs – est. annualised GWP US$95m, agreed and expected to launch soon
- Four programs in advanced DD – est. annualised GWP $52m

Europe

- 16 programs – est. annualised GWP £281m, agreed and launched
- Six programs – est. annualised GWP £52m agreed, awaiting regulatory approval
- Six programs in advanced DD – est. annualised GWP £109m

Pipeline

- Strong US and Europe pipelines - programs at various stages of review and due diligence
- Further pipeline includes programs with an estimated annualized GWP above c.$400m pa
- Targeting 5% of GWP overall gross commission rate

Source: R&Q interim results presentation

The division is positioned to meet growing demand in Europe and the US from Managing General Agents (MGAs). The MGA generates and services the business on behalf of highly rated Program insurance carriers able to provide a full range of insurance licenses, and which act as the conduit between each MGA and the reinsurance market.

R&Q's owned Insurance Companies have held **AM Best A- (Excellent)** financial strength ratings for some time. Earlier this year saw an increase in the financial size category from AM Best to reflect its enhanced balance sheet. That is an additional attraction for MGAs and their producing Brokers' assessment of Accredited companies as Program partners.

In Europe particularly, Accredited has benefited from the retrenchment of certain former Program specialists. It has competitors, but there are significant barriers to entry from which the division derives its competitive advantages. Both its US domiciled company, Accredited Surety and Casualty, Inc. and its European sister company, Accredited Insurance (Europe) Limited (domiciled in Malta), can provide high quality oversight through monitoring claims and back office processes, corporate governance and regulatory compliance.

All of that is reflected in recent growth and its new business pipeline, despite its selective criteria regarding MGAs its willing to support and classes of business it will underwrite.

Re Brexit, the division has established a UK branch of its Maltese entity to enable it to continue underwriting and servicing UK business. The Malta Home Office operation will continue to support clients in all remaining EU Member States in the event of a hard Brexit scenario.

Market conditions remain conducive to further growth

The division is well placed to take advantage of its strong competitive positioning, derived from comprehensive licences and planned expansion into US Excess and Surplus markets.

Program Management – growth prospects

MARKET DRIVERS

- Solvency II has exposed undercapitalised program management specialists in Europe
- Reduction of independent program management capacity in the EU and US in 2018 (for example, the new ownership of State National)
- Uncertainty over Brexit (over 650 EU companies passport into UK)
- Growing demand from entrepreneurial MGAs to find strong, well rated capacity partners
- Fall out from Lloyd's Syndicates exiting certain classes of business

R&Q'S ENABLERS

- Group's comprehensive licences and planned expansion into US Excess and Surplus markets
- Ability to provide a credible "Brexit Solution" for insurers seeking continued access to the EU markets
- Strong credit rating (Accredited US now A- VIII).
- R&Q believes it is a natural partner for "disrupters" because we have no traditional business to defend

Source: R&Q interim presentation

Brexit presents no issues for program growth

It has a credible 'Brexit Solution' for insurers seeking continued access to the EU markets and its profile is underpinned by a strong AM Best credit rating. It believes it is a natural partner for "disrupters" as it has no traditional business to defend and is well placed to capitalise upon growing demand from entrepreneurial MGAs to find strong, well rated capacity partners.

Some of the group's competition has struggled as Solvency II exposed undercapitalised program management specialists in Europe and there was a reduction in independent PM capacity in both the EU and US during 2018. Additionally, uncertainty over Brexit outcome is driving business to providers with a ready solution (over 650 EU companies passport into UK).

Investment earnings

Although it is integral to the two divisions, investment earnings are split out in the segmental report, which shows that it contributed 14.4% of H1 19 total income (H1 18: 2.1%, FY18: 6.7%) is notable.

There was a significant increase in the investment return to 2.3% vs 0.7% for H1 18. This reflects positive investment markets during which R&Q recovered all unrealised losses sustained towards the end of 2018. That coincided with an overhaul of R&Q's investment portfolio. It disposed of almost all equity investments and rationalised its third-party investment managers to reduce expenses.

It has continued to invest in high grade securities, and we have assumed a lower percentage investment return on a lower risk portfolio in future periods. The net effect will be part offset by growth in the insurance float, which was £729m at the end of June 2019, up by c 25% y-o-y.

Summary P&L

Y/e 31 Dec, £'000s	**2017**	**2018**	**2019e**	**2020e**
Net Premiums Earned	168.7	63.4	190.0	250.0
Investment and other income	16.3	17.4	29.0	18.0
Total income	**185.0**	**80.8**	**219.0**	**268.0**
Gain/(loss) Net insurance claims incurred	-109.0	10.7	-130.0	-144.0
Operating expenses	-84.4	-77.3	-87.0	-90.0
Adj. operating profit*	**-8.4**	**14.2**	**2.0**	**34.0**
Other - neg. goodwill/amort. & impairment of intangibles	22.8	4.4	50.0	15.0
Operating result	**14.3**	**18.6**	**52.0**	**49.0**
Interest (net)	-4.2	-4.3	-10.0	-10.0
Share of loss of associate	-0.3	0	0	0
Pre-tax profit from continuing operations	**9.8**	**14.3**	**42.0**	**39.0**
Income tax (charge)/credits	-0.3	-3.9	-8.4	-7.8
Profit after tax - continuing operations	**9.5**	**10.3**	**33.6**	**31.2**
Profit from discontinued operations	13.5	-2.5	0.0	0.0
	23.0	**7.8**	**33.6**	**31.2**
EPS - continuing operations (basic), p	10.5	7.8	18.3	15.9

Source: R&Q, Analyst forecasts

**Operating result before goodwill on bargain purchase and intangibles impairment*

Investor Access

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