Capital Access Group

Randall & Quilter

Update Note

04 July 2019

Ramping, & Quickly

The full year results released at the end of April met revised expectations and guidance given that they were impacted by the delayed completion of several Legacy acquisitions. These transactions, including Global Re, have now closed and will feature in 2019 results.

In the meantime, Randall & Quilter's strategy to invest in two key businesses with different capital requirements and complementary earning patterns is bearing fruit.

Legacy continues to provide opportunities for growth, with a strong pipeline and market tailwinds. This is also a Brexit proof and recession resistant model. The completion of the Global Re deal is transformative, and demonstrates that large scale transactions are achievable.

Program Management hit its ambitious Contracted Gross Written Premium target for 2018, and growth continues apace as the competitive advantage of its high-quality insurance paper pays dividends in a market in which many Lloyd's insurers are reducing their new business

In other developments, the successful capital raising, the AM Best ratings upgrades, and inclusion in the AIM 100 index are all positive developments. Finally, the question over succession planning, which had been of concern to some investors, has been convincingly answered.

In summary demand is strong in both businesses, the platforms are scalable, and the respective markets are changing shape in favour of Randall & Quilter's offering. The balance sheet is in good shape and ready for further acquisitions. Management continue to be adaptive and entrepreneurial, and yet maintain a sensible approach to risk. As a result of all this, we expect the business to continue to perform well.

Consensus is thin due to the limited coverage, but forecasts for Randall & Quilter's adjusted 2019 EPS come in at around 18p/share. Consensus distribution and Net Tangible Assets (NTA) per share also increased.

The valuation remains undemanding, at a 5.2% yield and a significant P/E discount to the larger Life consolidators.

Group Reporting

Year to January, £'000	FY18A	FY19E (Cons)	YoY Growth
Revenue (GWP)	£183,838	£221,000	20%
Operating Profit	£18,596	£47,500	155%
Net Income Adj+	£9,824	£34,900	255%
EPS, Adj+	£0.078	£0.181	132%
EPS, Reported	£0.058	£0.194	255%
Distribution per share	£0.092	£0.094	2%
NTA per share	£1.236	£1.312	6%
Ratio: Distribution to NTA	7.4%	7.2%	
P/E (Adj.)	25.6x	11.0x	
Yield	4.6%	4.7%	
P/NTA	1.6x	1.5x	

Price 184p

TDIM
RQIH

Market Cap
£361m

Net Cash (A)
£96m

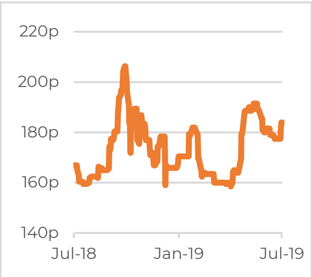
Free Float
89.8%

Average Daily Volume
184k

Broker
Numis
Shore Capital

Listing
AIM

Share Price Performance



Source: Bloomberg

Following a re-focusing exercise in 2017, Randall & Quilter now operates two discrete business lines. The larger of the two, Legacy, assumes the assets and liabilities of closed or "run-off" insurance books. Program Management (or 'Live') offers regulatory cover and reinsurance for Managing General Agents who wish to insure books while continuing to do most of the operational work.

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Legacy

As detailed in our initiation note, in Legacy Randall & Quilter assumes the assets and liabilities of insurance books which are in "run-off" or closed to new insured members. These books tend to fall into two main categories: The first are insurance products that the provider no longer wishes to offer but where they retain the liabilities and assets as a 'legacy' book. Secondly, captive insurance. These products were created by larger companies with significant risk exposure (e.g. employee health claims) that in a previous regulatory environment it made sense to keep on their own balance sheet rather than paying a third party to insure.

The big news here was the completion of the Global Re acquisition, which completed in May 2019. This deal involved $260m of assets and according to their September 2018 RNS "Based on R&Q's own reserve assessment and significant operational synergies, the acquisition will generate a material gain."

There have been subsequent large transactions, including (announced 3rd July, see appendix 1) taking on coverage of up to $113m by way of a Loss Portfolio Transfer Agreement.

This demonstrates that Randall & Quilter can:

(i) successfully find and execute large transactions. Management anticipate making further acquisitions on this scale where the returns justify them. Regardless of size, the pipeline remains strong, evidenced by the numerous acquisitions announced and made YTD, as detailed in Appendix 1; and

(ii) Deploy a broad and innovative toolkit (i.e. not just acquisitions) to be flexible in procuring suitable portfolios.

The various methods by which Randall & Quilter profit from such legacy acquisitions are explained in Appendix 3. A further benefit of the increasing number and size of Legacy acquisitions is the spread of claims risk. Pursuant to the law of large numbers, the more policies covered by Randall & Quilter, the closer the overall claims outcome will adhere to expected probabilities and the more predictable returns can become. It also reduces the risk posed by a single portfolio achieving a worse than anticipated outcome.

The market continues to evolve in favour of Randall & Quilter's business model. Firstly Lloyds is reviewing its markets to identify underperformers. It's likely some of these portfolios will be closed and thus, given Randall & Quilter's good relationship with many syndicates, may present opportunities to further grow the Legacy business.

Secondly, Solvency II continues to impact captive insurance operations, often rendering closed books equally as expensive and time-consuming to operate as open books. As such, for regulatory purposes it's unattractive for corporates to hold closed books of captive insurance risk. This means that disposal, even at a discount, can be the best option – thus providing Randall & Quilter with the opportunity to generate strong returns through taking on these books at attractive prices, and managing them well.

Program Management

Per our initiation note, the "live" business line encompasses Randall & Quilter's service offering to Managing General Agents (MGAs). As a business model, it is known as "fronting" in the US and "Program Management" in Europe. The MGAs are customer-facing insurance brokers who handle claims, price risk, issue policies, process endorsements, and collect policy premiums.. Operationally Randall & Quilter acts as the MGA's insurer principal (partner), providing them with access to its licenses and regulatory infrastructure. Randall & Quilter de-risks the relationship through extensive due diligence, ongoing monitoring of risk pricing/growth, and by re-insuring the overwhelming majority of the risk. Therefore in contrast to the legacy business, Program Management requires limited capital. Randall & Quilter charges the MGA a commission on business written through its structures.

Randall & Quilter wrote 30 contracts across Europe and the US in 2018, which are expected to deliver the promised $500m of Gross Written Premiums per annum. It's worth noting that this will only get recognised into Earned Premium and Earned Commission over 2 years as illustrated on page 6 of our initiation note, and in various company presentations. One thing common to the presentations is that they assume a contract expires after one year. Realistically, given the lack of competitors of a comparable quality, once a solid and profitable relationship is entered into the MGAs are likely to renew the contract; and if they've grown in the meantime then so will the contract. Similarly if Randall & Quilter has done its due diligence well, it should have no reason not to renew.

In the market in 2018 several European Program writers closed down due to being poorly capitalised. This has fuelled demand for Randall & Quilter's services due to the quality of the insurance paper that underwrites them. Having to seek alternative insurance capacity can represent a significant business and reputational cost for an MGA, so stability is key. This all adds credibility to the business case for Live.

Finally, the B-word: Randall & Quilter is well placed to weather any Brexit outcome, with insurance licenses in the UK, Europe, and the US. The combination of its Maltese and UK base of operations means it will be able to continue to write business anywhere post-Brexit: something not all competing insurers can claim. Many of these insurers may end up selling their UK businesses, providing further opportunity for Legacy acquisitions.

Thus, Program Management could become a visible, repeatable, and growing income stream. Management have re-iterated that since the year-end the Live business is "showing continued growth momentum" so we expect significant growth in 2019.

Investment Portfolio

2018 was at first glance a difficult year, but this was largely due to the timing of the year end – the investment portfolio was negatively impacted by c.£2.9m due to the equity market collapse in Q4. However, along with markets the portfolio recovered this loss in Q1 2019. This volatility was apparently caused by an acquired equity portfolio that was exited during Q1 2019 having recovered its loss. As a result of this volatility, the portfolio will henceforth be invested primarily in fixed income products, which should avoid a repeat of the provisioning required at the year-end 2018.

FY19 investment income could increase significantly – over 2018 interest rates in the US (where 70% of the portfolio is invested) rose sharply, resulting in T-bills yielding >2%: well above the 0.4% achieved in the prior year.

Further, the float has increased significantly in size; from c.£639m at the end of December 2018 to over £800m now the Global Re deal has completed. Consequently management have indicated that they are comfortable with the "strong uptick" implied by consensus expectations in 2019. The float will continue to grow with each additional portfolio, offering further potential for growing investment returns.

A key risk has appeared though - recent commentary the Federal Reserve suggests that we are no longer so obviously in a rising rate environment. Randall & Quilter has recently increased its exposure to floating rate notes, so a cut in rates could have a negative impact on investment income.

AM Best Rating Increase

Accredited, Randall & Quilter's US insurance company, has had its A.M. Best Group rating increased from VII to VIII. The rating increase reflects the increased balance sheet strength of Accredited (and Randall & Quilter) following the equity (£107m) and debt capital ($70m) raises in March 2019 and December 2018 respectively.

This is supportive of further Program Management growth because counterparties are focused on the financial strength of the insurer and its associated group.

Board Changes

Ken Randall is to step down as Group CEO, though he will continue to act as Executive Chairman of the Group. Alan Quilter and Dr Roger Sellek are to be appointed to the newly-created positions of Joint Chief Executive Officers.

Roger Sellek joins R&Q from AM Best, the leading international credit-rating agency focused on the insurance sector, where he was CEO with responsibility for the group's worldwide activities ex-Americas. Roger was with AM Best for 12 years, initially based in London and relocating to Singapore in 2015.

Given that Randall & Quilter already has a strong relationship with AM Best, this can only strengthen it. It also addresses the concerns that some investors had expressed over succession planning within the business.

Management have known Dr Sellek for a long time, and have been in discussions with him since late 2018, showing that succession planning has very much been at the forefront of their minds.

The team are reported to be delighted with the appointment and believe, as do we, that this represents a positive development. Ken will continue to play an active role in the executive team, providing the best of both worlds – combining his and Alan's experience with 'new blood'.

AIM 100 Inclusion

Since 13th May, RQIH has been included in the FTSE AIM 100 index, providing it with increased exposure.

Successful Capital Raising

The oversubscribed new share issue in March 2019 raised £103.5m after costs, and $70m of subordinated debt was issued and listed. This strengthening of the balance sheet has already had a material impact as it fed into the rating upgrade issued by AM Best.

Return of Capital

The return of capital, to take place around 19th June, will see shareholders issued with one AB Share for each ordinary share they hold. The AB Shares have a par value equal to the declared distribution per share (5.6p/share this year) and will be cancelled immediately and holders of the AB Shares will be paid the par value of those Shares.

This is subtly but cleverly different to the usually buyback approach because shareholders get the benefit a dividend-like guaranteed cash inflow, whilst retaining the benefits associated with receipt of capital gains over receipt of income. A straight buyback relies on the market to re-value the shares post-buyback based on a reduced number of shares outstanding, so is less reliable.

Cash Flow

Cash flow is very important to understanding Randall & Quilter due to the volatility in profits booked in the Legacy business, but Legacy does impact cash flow too:

Group Cash Flow Highlights

£'000	2H17A	FY17A	1H18A	2H18A	FY18A
Profit for the period	17,025	22,970	4,974	2,848	7,822
Finance costs	2,416	4,204	2,360	1,985	4,345
Goodwill on bargain purchase	(18,244)	(24,666)	(1,173)	(4,824)	(5,997)
Fair value loss/(gain) on financial assets	(770)	(2,728)	1,455	4,299	5,754
(Increase)/decrease in receivables	5,524	8,121	(73,426)	11,692	(61,734)
Purchase of financial assets	(105,831)	(161,010)	(61,212)	15,189	(46,023)

As the Cash flow summary highlights, the first half of 2018 saw a large increase in receivables (£73.4m) which was directly attributable to a large earlier Legacy acquisition. This highlights the impact of Legacy on cash as well as earnings. We expect Live to lessen this impact on working capital as it becomes a larger contributor to cash flow.

Segmental Results

The progress of both businesses and the investment income is shown in the table below. There are several points to note within this analysis. Legacy's total income can vary significantly between accounting periods, determined by the rate and size of new book acquisition.

Total income at Live is also variable within this timeframe but we believe that this is a product of the 'youthful' status of this business and that this volatility will reduce as it achieves critical mass. Thus it's likely that the introduction and continued growth of the Live business will improve the earnings visibility and more closely align them to cash flow. In turn, this is likely to improve the consistency of free cash generation.

Segmental Reporting

Live, £'000	FY17A	1H18A	2H18A	FY18A
Earned Premium, net of reinsurance	£45,232	£21,822	£16,853	£38,675
Net Investment Income	£689	£634	-£1,013	-£379
Total Income	£47,811	£23,848	£17,404	£41,252
Op Profit before goodwill on bargain purchase	-£4,815	£3,360	-£7,162	-£3,802
Result of operating Activities	-£5,565	£3,284	-£7,086	-£3,802
Finance Costs	-£19	-£122	-£100	-£222
Profit/(loss) on ordinary activities before income taxes	-£5,868	£3,162	-£7,186	-£4,024
Profit/(loss) for the period	-£6,915	£2,846	-£6,644	-£3,798

Legacy, £'000	FY17A	1H18A	2H18A	FY18A
Earned Premium, net of reinsurance	£123,438	£91,706	-£66,932	£24,774
Net Investment Income	£12,886	-£947	£6,039	£5,092
Total Income	£142,229	£91,834	-£58,076	£33,758
Op Profit before goodwill on bargain purchase	£22,711	£11,457	£15,398	£26,855
Result of operating Activities	£46,263	£11,879	£19,019	£30,898
Finance Costs	-£5,297	-£3,178	-£3,090	-£6,268
Profit/(loss) on ordinary activities before income taxes	£40,966	£8,701	£15,929	£24,630
Profit/(loss) for the period	£36,734	£7,831	£6,483	£14,314

Other, £'000	FY17A	1H18A	2H18A	FY18A
Earned Premium, net of reinsurance	£0	£0	£0	£0
Net Investment Income	£4,795	£7,362	£8,748	£16,110
Total Income	£21,349	£18,845	£19,599	£38,444
Op Profit before goodwill on bargain purchase	-£16,152	-£570	£7,153	£6,583
Result of operating Activities	-£16,197	-£594	£7,487	£6,893
Finance Costs	-£9,071	-£3,489	-£9,759	-£13,248
Profit/(loss) on ordinary activities before income taxes	-£25,268	-£4,083	-£2,272	-£6,355
Profit/(loss) for the period	-£20,302	-£3,675	£3,464	-£211

Consolidation, £'000	FY17A	1H18A	2H18A	FY18A
Earned Premium, net of reinsurance	£0	£0	£0	£0
Net Investment Income	-£10,183	-£4,429	-£10,964	-£15,393
Total Income	-£26,378	-£12,641	-£19,974	-£32,615
Op Profit before goodwill on bargain purchase	-£10,183	-£4,429	-£10,964	-£15,393
Result of operating Activities	-£10,183	-£4,429	-£10,964	-£15,393
Finance Costs	£10,183	£4,429	£10,964	£15,393

Total, £'000	FY17A	1H18A	2H18A	FY18A
Earned Premium, net of reinsurance	£168,670	£113,528	-£50,079	£63,449
Investment Income	£8,187	£2,620	£2,810	£5,430
Total Income	£185,011	£121,886	-£41,047	£80,839
Op Profit before goodwill on bargain purchase	-£8,439	£9,818	£4,425	£14,243
Result of operating Activities	£14,318	£10,140	£8,456	£18,596
Finance Costs	-£4,204	-£2,360	-£1,985	-£4,345
Profit/(loss) on ordinary activities before income taxes	£9,830	£7,780	£6,471	£14,251
Profit/(loss) for the period	£9,517	£7,002	£3,303	£10,305

Consensus Forecasts

As we stated in our initiation note, we do not intend to maintain a forecast model for Randall & Quilter. Rather, we have assessed the consensus forecast for the company:

Consensus Forecast

Year to January	FY 2019 Est	FY 2020 Est	FY 2021 Est
Operating Profit	£47,500,000	£47,487,667	£55,200,000
PBT	£41,466,667	£39,561,000	£47,300,000
EPS, Adj+	£0.18	£0.16	£0.20
EPS, Reported	£0.19	£0.17	£0.21
Distribution per share	£0.09	£0.10	£0.12
Payout Ratio	52.1%	59.6%	60.2%
Operating Profit	£47,500,000	£47,487,667	£55,200,000

The company is covered by three broking firms; Numis Securities, Shore Capital, and Equity Developments. The above highlights the average of their forecasts for the KPIs shown. PBT is notoriously 'lumpy' and unpredictable given that it depends on the level of profit booked from Legacy acquisitions, which are themselves entirely unpredictable.

In terms of ranges within this analysis, there is a 15% difference between the lowest and highest FY19E Operating profit, which whilst material isn't entirely unreasonable. Interestingly the mode is £50m, significantly ahead of the mean. Variation is to be expected given that the year-end (December) is still remote and there remains (positive) growth uncertainty in both divisions this year as Legacy continues to add risk portfolios and Live really ramps up.

There is also a lag in the impact of Live growth as explained in our initiation note – premiums are received and recognised gradually over the 12 months following the signing of a program underwriting contract.

Reasons to be optimistic about growth are myriad, including management guidance on Program Management growth, the numerous transactions announced in both Live and Legacy businesses (see Appendix 1: 2019 YTD Acquisitions and New Partnerships), and the ongoing structural tailwinds in the Legacy market.

FY19 Est dividend/distribution forecasts show restraint, at a c.2.5% consensus growth to 9.4p per share, and 4% growth rate for FY20 Est. We believe this could be pessimistic in light of the significantly improved profit levels, but we do foresee management caution until Program Management has a longer track record of growth and earnings have built up.

Valuation

Randall & Quilter has few immediate peers from a valuation perspective. We believe that the shares are valued by the market with reference to a range of comparative ratios set against more general insurance sector metrics.

Randall & Quilter looks cheap on an earnings basis, at 10x FY19e EPS vs. the listed life insurance consolidators on 14.5x. Whilst they are much larger, these businesses don't have the same growth profile as Randall & Quilter, particularly with regard to the 'new' Program Management business, so if anything one could justify valuing Randall & Quilter at a P/E premium.

Similarly, based on consensus dividend for FY19 Randall & Quilter currently trades on a yield of 5.2%, which given the potential for growth in the dividend and the improving risk profile seems unreasonably cheap. It's worth noting that the life insurance businesses Phoenix Group and Chesnara trade on 6.7% and 6.1% respectively, but they are in actuality very different businesses.

Given the significant changes the business has undergone in FY18 and FY19 YTD we no longer think PEG is a relevant guide to the valuation – we expect to re-instate this metric after FY20 has closed.

Appendices

Appendix 1: 2019 YTD Acquisitions and New Partnerships

Date	Deal Type	Asset/Deal Name	Category	Asset/Deal Description
Announced 19/09/2018 Completed 03/05/2019	Acquisition	Acquired GLOBAL U.S. Holdings Incorporated from AXA DBIO, SCA	Insurer	New York domiciled insurance company in run-off that underwrote predominantly property and casualty pro-rata treaties and facultative business for regional and specialty insurance companies on non-standard automobile, multi-peril and general liability lines in the US. In August 2002, it went into run-off and was acquired by an investment vehicle managed by AXA LM in June 2014.
Announced 02/10/2018 Completed 01/04/2019	Acquisition	Western Captive Insurance Company Designated Activity Company ("WCIC")	Captive	Acquired WCIC from the Coffey Group of companies in Ireland
21/03/2019	Program Underwriting Partnership	Pronto General Insurance Agency LTD ('Pronto') in California	Live	U.S. MGA providing a variety of coverages in Texas and California, including its expanding California car insurance business on behalf of which R&Q will be the insurer principal.
04/03/2019	Acquisition	Nationale-Nederlanden Internationale Schadeverzekering	Insurer	The residual liabilities comprise NNIS's exposures arising in relation to the Dutch Aviation Pool for years 1996 and prior.
25/02/2019	Program Underwriting Partnership	Stabilis MGA Ltd.	Live	UK MGA providing car insurance, on behalf of which R&Q will be the insurer principal.
10/01/2019	Not Disclosed	Not Disclosed	Captive	Transaction to assume the Workers' Compensation liabilities of a Vermont based self-insurer. The transaction provided full finality to the self-insurer and has removed the barrier for the ultimate dissolution of its Workers' Compensation Trust.
10/01/2019	Novation	Not Disclosed	Captive	Reinsurance policies issued between 2002 and 2009 from a Cayman domiciled group captive providing Workers' Compensation coverage to its members throughout the United States.
Announced 19/09/2018 Completed 08/01/2019	Acquisition	MPS Risk Solutions Limited	Captive	The residual liabilities comprise primarily Professional Liability exposures arising in the UK. MPSRS had gross claim reserves as at 31st December 2017 amounting to £2.4m.
07/01/2019	Program Underwriting Partnership	Kitsune Ltd	Live	UK MGA providing private motor insurance.
03/01/2019	Program Underwriting Partnership	CPD Underwriting Solutions Ltd	Live	UK Managing General Agent ("MGA") providing both private motor and household insurance.
01/07/2019	Acquisition	Sandell Re	Insurer	Net assets of $40.8m, cash consideration is $25m + earn outs.
03/07/2019	Loss Portfolio Transfer*	Joint Powers Authorities** in California	Captive	$113m of total coverage acquired, focused on property and general liability cover

*A "Loss Portfolio Transfer" is an agreement in which an insurer cedes policies to a reinsurer that have already incurred losses. The reinsurer assumes and accepts an insurer's existing open and future claim liabilities through the transfer of the insurer's loss reserves.
**A "Joint Powers Authority" is an entity in the US, whereby two or more public authorities (e.g. local governments, or school districts) may share powers such as purchasing, administrative work, or insurance in order to achieve economies of scale.

Appendix 2: Randall & Quilter "risk flow"

Appendix 3: Legacy transaction impact

Randall & quilter profits from the acquisition of legacy insurance books in four ways:

(i) They typically acquire the books at a discount to NAV, crystallising an immediate 'fair value' profit;

(ii) They improve the claims management process, typically reducing the lifetime claim value of the book compared to prior expectations. Claims management is a core expertise at Randall & Quilter, and they seek reductions in the size and number of outstanding claims in acquired books;

(iii) They employ specialist experience and economies of scale improve operations and reduce costs;

(iv) Additional float: each Legacy portfolio is accompanied by assets that generate investment returns.

This first point is what accounts for the lumpiness of profits in the Legacy division. The size of, quantity of, and discount achieved on deals all impact profit. Unfortunately these are all unpredictable factors, making it very difficult to forecast profit levels. However, it's worth noting that there is no cash impact from this.

Below is a simplified illustrative example of the impact on the accounts of the purchase of a book below its NAV, using 'Bargain Purchase' accounting:

Impact on:	Balance Sheet	Cashflow	Profit/Loss
Cash out for acquisition	-£100	-£100	
Assets received (at book value)	£120		
Profit booked			£20
Net change to Assets:	**£20**		
Addition to Retained Earnings	£20		
Net change to Equity:	**£20**		

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