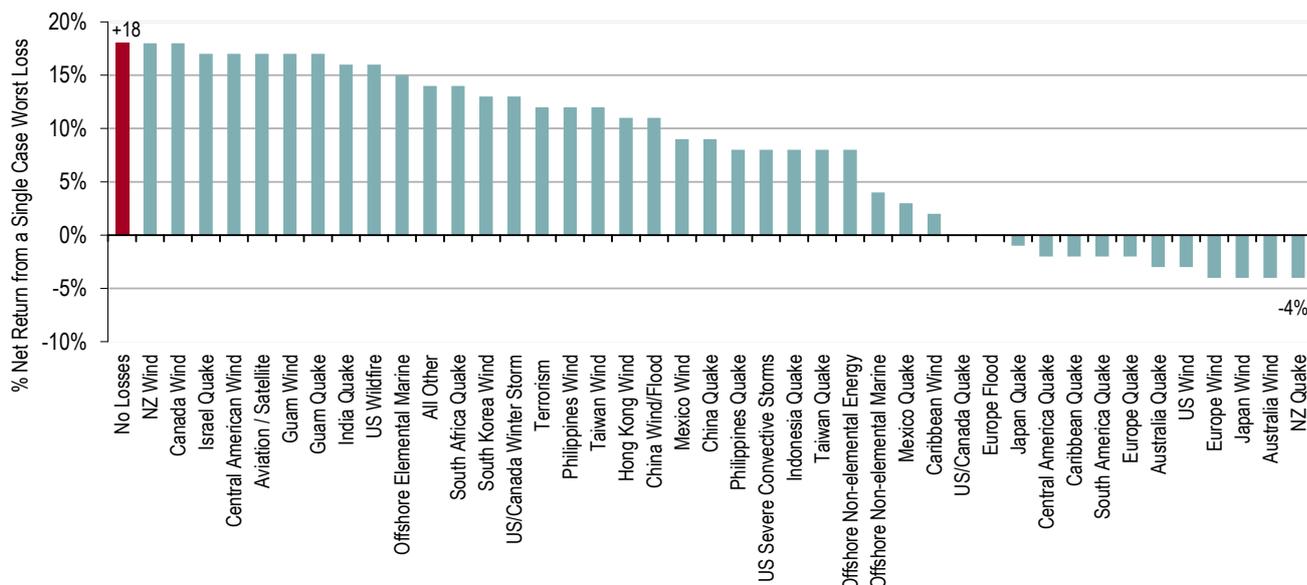


## Sector Specialist - Reinsurance

### CATCo Reinsurance Opps\* – 18% potential net return from 2014 invested portfolio at lower risk

- CATCo has released an update providing details of its 2014 portfolio following the January renewal, as well as a more detailed attribution for the fund's NAV return for 2013 of 21.9%.
- **2013 NAV Performance:** The NAV increased by 21.9% over the year to \$1.1059 at 31 December, and the share price rose by 24.3% on a total return basis. The maximum net return on the portfolio was 27% at the start of 2013, but this was reduced by three key factors:
  - Cash drag of 3.4% as capital released from historic side pocket investments could not be deployed.
  - Loss reserves of c.1% relating to minor exposure to US/Canada tornados
  - Around 1% of net assets was spent on portfolio protections which reduced the risk of the portfolio in the last two months of 2013.
- **2014 Portfolio:** The maximum, no loss net return from the portfolio is 18% (allowing for an estimate of all management and performance fees). The portfolio is invested across 42 non-correlated risk pillars, and this diversification means that worst net portfolio return for the year as a result of any single catastrophe would be -4%. We understand that the counterparties and overall mix of perils comprising the 2014 portfolio is similar to 2013.

### CatCo – Worst Case Single Event Portfolio Net Returns in 2014



Source: CatCo as at 30 September 2012

- **Pricing Pressure:** There has been significant pricing pressure in the catastrophe reinsurance market due to a strong inflow of capital into Insurance-Linked Strategies during the year, and a relatively low level of global catastrophe losses during 2013 (Munich Re estimates losses of \$31bn versus a ten year average of \$60bn). In addition, some counterparties have reduced their retrocessional purchases for 2014 as capital surpluses are high following a benign year for traditional

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reinsurance. The Guy Carpenter Global Property Catastrophe Reinsurance Rate-on-Line Index fell 11% at the 1 January 2014 renewal, but CATCo states that pricing fell 25% to 40% year on year in some segments of the market. Despite this competitive environment, CATCo maintained its investment discipline, and only considered transactions that met or exceeded its return of LIBOR plus 12-15% pa. To-date, 85% of its available capital has been utilised.

- **2014 portfolio is 20% lower risk:** For 2014 reinsurance contracts written at comparable risk levels to 2013, the indicative net returns are 25%, representing a decline in premiums of c.7.5% from 27% in 2013. However, a third of CATCo's 2014 capital was deployed into reinsurance contracts with 40% lower average expected loss rates (i.e. 40% lower risk), which reduced the maximum 2014 portfolio net returns to 21%. In addition, 3% of the available capital was used to acquire protections to further reduce risk exposure, resulting in an overall net return on the 2014 investment portfolio (assumed no losses) of 18%. Overall, the portfolio's risk level is 20% lower in 2014 than in 2013 portfolio. This reduction in risk is difficult to assess based simply on the chart of worst case scenarios by peril (shown above), but higher average attachment points and protections purchased, mean that the likelihood of losses occurring is reduced.
- **Utilisation of remaining capital:** As a result of CATCo's pricing discipline, the listed fund is returning 20c per share (\$74m) to investors (which can be treated as a capital or income distribution), in addition to the annual dividend of 5.737c per share (based on Libor plus 5% of year-end NAV). To-date, 85% of available capital has been deployed by the Master Fund to-date, suggesting that investors may suffer significant dilution from cash drag in 2014. The managers aim to deploy much of this capital in the next few weeks and, if necessary, would consider returning some capital to investors in the Master Fund (this would not impact the listed fund).
- **Remaining side-pockets:** Earlier this week, CATCo announced a distribution of 2.887c per share payable on 24 January to Ordinary shareholders on the register on 8 August 2012 (prior to the merger with the C shares). This followed a recovery from the Master Fund's exposure to the Tohoku earthquake in Japan, following an agreement with a reinsurance counterparty. CATCo stated that there remains little change in the exposure to Super-storm Sandy and no adjustment has been made to the retrocessional reinsurance loss reserve previously established. At 31 December 2013, total claim payments made to reinsured counterparties amounted to c. 41% of the original retrocessional reinsurance loss reserve. This side-pocket was equivalent to 3.4% of the NAV at 31 December 2013 (but is fully provided-for, meaning that there is now only upside for investors in CATCo should there be a recovery of value).
- **Performance since launch:** The number of major catastrophes since CATCo was launched in late 2010 has been unprecedented. Since then, the fund has been hit by the Japan tsunami/quake and the NZ quake, as well as Costa Concordia and Hurricane Sandy. In addition, there have been floods in Australia and Thailand, as well as Hurricane Irene in the US (CATCo suffered no losses as a result of these events). Despite this, CATCo still delivered attractive positive NAV total returns, as illustrated below (75% of the fund's capital was raised via the two C share issues in 2011):
  - Ordinary shares issued in Dec-10: +8.5% pa (exposed to Japan, New Zealand, Costa Concordia & Sandy).
  - C shares issued May-11: +15.3% pa (exposed to Costa Concordia & Sandy)
  - C shares issued Dec-11: +13.9% pa (exposed to Costa Concordia & Sandy)
- **Numis views:** Given the highly competitive pricing environment in the reinsurance market, we believe that the 7.5% fall in CATCo's rates on a constant risk basis is an encouraging outcome. This has been achieved through a combination of limiting capacity (the Master Fund is hard closed) and a unique multi-pillar approach focused on retrocessional

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reinsurance. In our view, the potential returns from CATCo's portfolio for 2014 remain attractive, particularly given the 20% reduction in risk. CATCo's current share price of \$1.126 represents a premium of 1.8% to the year-end NAV.

*\* Denotes that this company is a corporate broking client of Numis Securities.*

*Note: all prices, NAVs and discounts as at close of business at 15 January 2014 unless otherwise stated.*

*The research analysts who prepared this report were Charles Cade and Ewan Lovett-Turner*

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