Sector Specialist - Reinsurance

CATCo Reinsurance Opportunities* - No loss net returns from 2015 portfolio of 19%

- CATCo has released its December NAV, as well as a summary of the risk/return characteristics of its 2015 portfolio following the January reinsurance renewals.
- **NAV performance**: The NAV as at 31 December was $1.1981, up 0.9% over the month. Adjusting for the 5.737c dividend paid in early 2014, the NAV return for the year was 14.08%. This compares with the company's target for gross portfolio returns of Libor plus 12-15% pa, and a return from the Eurekahedge Insurance Linked Securities Advisors Index of 4.96% in 2014. This followed on from an NAV return for CATCo of 21.9% in 2013.
- **Returns from 2015 Portfolio**: The expected net return on the 2015 portfolio is 19%, assuming no losses, which is marginally higher than last year. Furthermore, the average risk per pillar has decreased to 3.3% versus 4.1% in 2014. Industry pricing in 2015 has been impacted by the lack of significant insured losses incurred in 2014, with reinsurance rates down by 11% according to Guy Carpenter. However, CATCo has been able to deploy all of its capital at rates in excess of the company's target returns, helped by innovations in the structure of its reinsurance contracts. In addition, cheap pricing of Insurance-Linked Warranties (ILWs) has enabled the manager to hedge risk more efficiently – the price of ILWs has fallen 15-20%, following on from a fall of 30% the previous year.
- **Downside risks**: The maximum loss to any single event, regardless of the magnitude, would result in net portfolio returns for investors of no worse than -10% (relating to 1 in 100 year type events). This maximum single event exposure is a little higher than -8% last year, but we understand that the risk is even lower (partly as a result of hedging).
- **50 Risk Pillars**: In the 2015 portfolio there are 50 non-correlated risk pillars, up from 42 in 2014. As would be expected the core risks relate to events such as US wind, US quake, Europe wind and Japan quake, but there are also events such as aviation, terrorism, Australian wildfire, and quake/wind in a variety of Emerging Markets.
- **Side-Pocket Investments**: There is a side-pocket for 2014 of 3.5% of NAV relating to US Convective Storms, but the manager states that these are not expected to result in losses. In addition, there is still a 2.8% side-pocket included in the NAV that relates to Super-storm Sandy in October 2012. Under CATCo's contracts, the reinsurers must commute the remaining liability by the end of 2015, and Tony Belisle, CATCo's CEO, believes that there could be an enhancement to NAV of 2-3% from a write-back of provisions relating to this event. This would enhance the return for investors in CATCo during 2015.
- **Dividend and Return of Value**: CATCo has today gone ex-dividend 5.929c per share, based on its regular annual distribution of Libor plus 5% (paid 30 Jan). In addition, it will make a further distribution of 11.528c per share ($35m) that can be treated as either income or capital (ex-date 28 Jan, paid 9 Feb). The default option is for the Return of Value to be treated as income. The aggregate of these distributions exceeds the portfolio return in 2014 of c.14c per share.
- **Management**: CATCo IM has recently appointed a new COO with significant insurance industry experience who is expected to join the group in March.
- **Background**: CATCo ($354m market cap) provides exposure to a portfolio of collateralised retrocessional reinsurance contracts written to provide reinsurers with protection against low frequency/high severity insured loss events such as hurricanes and earthquakes.
- **Numis Views**: Given the context of falling rates in the general reinsurance market, we believe that CATCo's portfolio for 2015 appears to have been invested on very attractive terms. The no loss net portfolio returns of 19% are higher than we had expected, particularly in the context of lower risk. The ability to buy ILWs cheaply due to over capacity in the market has

helped to reduce risks, while CATCo has been able to maintain strong pricing due to innovations in its reinsurance contracts. Strong demand from buyers has also enabled CATCo to deploy its full capital. Indeed, we understand that the manager has raised some further capital in the private fund in order to meet the demand. By comparison, CATCo's portfolio was only 85% invested at the start of 2014, resulting in some cash drag for investors. 6.3% of the NAV is currently held in side-pockets, which we estimate would reduce the expected no loss NAV return for 2015 to 17.8%. However, there is the potential for an uplift of 2-3% as a result of a write-back of provisions relating to Super-storm Sandy. We believe that CATCo's risk/return profile remains attractive, particularly given the low correlation to traditional asset classes such as equities and bonds. The shares are currently trading at $1.115, representing a 2.3% discount to the December NAV (adjusted for the regular dividend).

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

Note: all prices, NAVs and discounts as at close of business at 14 January 2015 unless otherwise stated.

The research analysts who prepared this report were Charles Cade, Ewan Lovett-Turner, Colette Ord and Sam Murphy.