09 January 2013

Companies: CAT

Sector Specialist - Reinsurance

CATCo Reinsurance Opps* - Portfolio Update

- CATCo has released an update on its portfolio, including details of net annualised returns for capital deployed in reinsurance contracts for 2013. There has been no change to the provision made last month for potential losses from Hurricane Sandy, but a full provision has now been taken for Costa Concordia Exposure to both these events has been moved to side-pockets of the Master Fund. We estimate that the side-pocket for Sandy represents c.7.52% by value of the current NAV. The Board has also declared a dividend of $0.05006 to be paid in March. The current share price of $0.935 represents a discount of 2% to the NAV of $0.9566 as at 31 December.

- **Hurricane Sandy**: There has been no change to the loss reserve announced by CATCo on 10 December based on an insured industry loss for hurricane Sandy of $20bn. Property Claim Services (PCS), the US industry loss compilation service, will provide an update on its initial estimate later this month, and CATCo will reassess its provision once this information is available.

- In late November, PCS released the results of its first survey based on direct information from insurers which put total insured losses at $11bn, although the "*estimate was caveated with a number of subjectivities that could result in the estimate increasing*". Modelling firms Eqecat, AIR Worldwide and RMS have all issued estimates of the expected insured loss from Sandy that range from $7 to $25 billion, with the average being c.$15 billion.

- The maximum impact on CATCo's gross expected returns for 2012 from US hurricane exposure was 27%, which would result in an expected gross return of 1% for the year (excluding the impact of Costa Concordia). However, the managers stated that this outcome is "*highly unlikely, given the range of expected loss occurrence probabilities on the contracts written*". Nevertheless, the Board of CATCo's Master Fund has taken a "cautious approach" and included a provision in the NAV at 30 November based on an insured industry loss for hurricane Sandy of $20bn. At this level, gross expected returns for 2012 were reduced by 13.2%. It emphasises that this is a reserve, and not a crystalised loss, as the Reinsurer's protections are based on the actual paid claims of the reinsurance counterparties through Ultimate Net Loss Contracts (UNLs).

- **Costa Concordia**: CATCo had exposure of up to 4% of gross returns for 2012 to marine events subject to industry losses being above $1.25bn. Initial loss estimates for Costa Concordia, the cruise ship that partially sank on 13 January 2012 off the Italian coast, were below this level. However, the industry loss estimate has risen due to an increase in clean up costs as the timetable for the wreck removal has been extended from January 2013 by three to four months. As as result, insured loss estimates have now risen to the $1.25bn trigger point.

- CATCo had exposure to Costa Concordia through two counterparties. In November 2012, the managers agreed to "*fully and finally commute 100% of the exposure*" with respect to one of the counterparties (representing c.40% of the total Offshore Marine portfolio exposure), for a cost of c.1.5% (which was included in the NAV calculation for October). At that time, CATCo indicated that it was seeking a similar agreement with the other reinsurance counterparty prior to the year-end. However, the Board has now taken a full provision for the remaining exposure.

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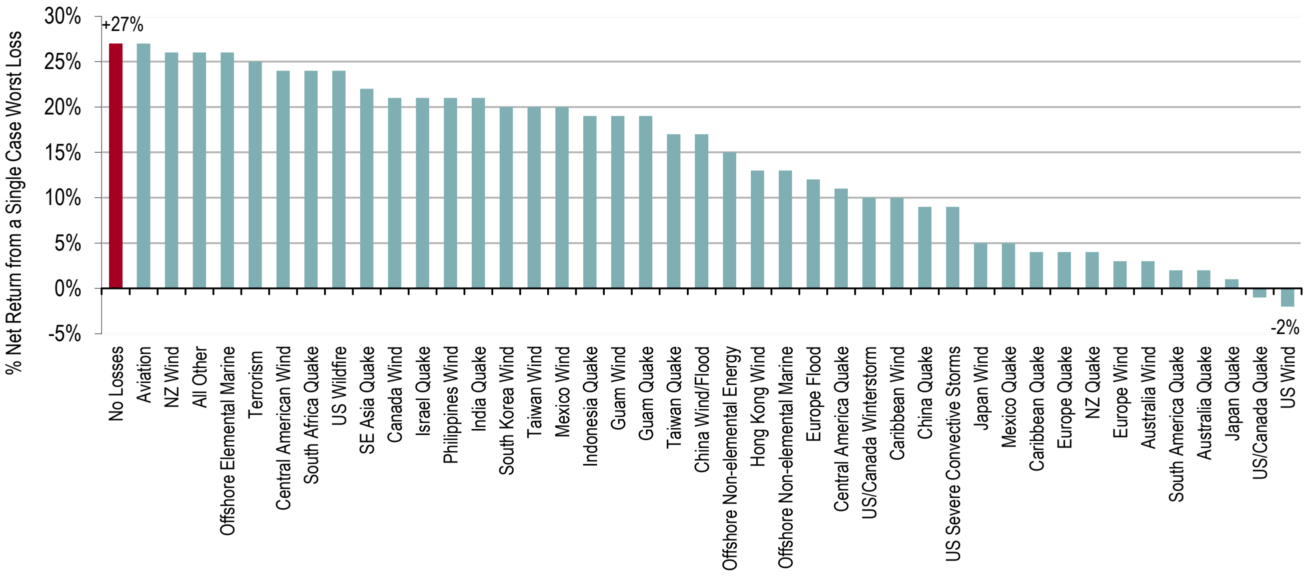
- **2013 Investment**: New reinsurance contracts have been written for 2013 with a range of counter parties. The risks are broadly spread across a diverse group of global events (with 42 non-correlated risk pillars) and the expected net return, assuming no losses, is 27%. This represents an increase from the maximum net return last year of 23%. The minimum expected return after any single event is -2% in the case of a full loss on the exposure to US Wind, but the exposure to most other events is far smaller (see chart below). These returns include reinsurance protections purchased by CATCo to reduce the exposure to specific events (gross portfolio returns before costs and protection are c.32%).

- The Master Fund received c.$350m of new investment for deployment as at 1 January, and at this date it had deployed over $2bn of retrocession reinsurance capacity, making it a major player in this market. 98% of all 2013 capital available has been deployed although this excludes the side-pockets for Hurricane Sandy (representing 7.52% of CATCo's NAV by value) and Costa Concordia (valued at zero), as well as reinsurance contracts written mid-year during 2012 (representing under 4% of 2013 exposure). At this stage, it is difficult to predict how long it will be before capital is released from the side pocket for Hurricane Sandy, but if it is assumed that no capital is available for reinvestment during 2013, we estimate that the net returns on the overall portfolio (assuming no change in the side-pocket valuation) would be reduced to c.25% for the year, based on no losses.

CatCo – Worst Case Single Event Net Returns in 2013 (excluding side-pocket)



Source: CatCo as at 30 September 2012

- **Dividend**: The fund has a commitment to pay a dividend equivalent to Libor plus 5% of the year-end NAV. Reflecting this, the Board has announced a dividend of $0.05006 to be paid in March, with an ex-dividend date of 16 January. This represents a yield of 5.35% based on the current share price.

- **Numis views**: 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 tsumami/quake and the NZ quake, as well as Costa Cordia 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, the majority of investors in CATCo by value have still made gains, as the C shares raised in May and December 2011 had no exposure to the losses in NZ/Japan. NAV total returns for investors at different dates are as follows:

  - Ordinary shares issued in Dec-10: +2.4% (exposed to Japan, New Zealand, Costa Concordia & Sandy).

- C shares issued May-11: +19.5% (exposed to Costa Concordia & Sandy)

- C shares issued Dec-11: +7.4% (exposed to Costa Concordia & Sandy)

- CatCo seeks to deliver a net return of Libor plus 12-15% pa in US dollar-terms from a diversified portfolio of catastrophe reinsurance contracts, an asset class that has demonstrated no meaningful historical correlation with equity or debt markets. We believe that the fund is far less complex and more transparent than conventional insurance companies, offering a pure play on retro-reinsurance rates, a market that is difficult for most investors to access. Furthermore, asset risk is minimised as the collateral is held solely in cash and cash equivalents.

- In our view, the potential returns from the portfolio in 2013 look attractive, even allowing for the Hurricane Sandy side-pocket. Premiums have risen following recent events and CATCo has increased its exposure to marine/energy exposures reflecting a 20% pricing increase after Costa Concordia, while its US property pricing is up 5-10% after Hurricane Sandy. Predicting the true risk based on historic events is not easy, but CATCo's diversification helps to limit the potential downside.

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

Note: all prices, NAVs and discounts as at close of business at 8 January 2013 unless otherwise stated.

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