twelve CAPITAL
info@twelvecapital.com
www.twelvecapital.com

Twelve Capital Perspectives 2H 2018 Outlook

Executive Summary

The US hurricane season has just commenced and is expected to last until the end of November. As Twelve Capital focuses across the entire balance sheet of insurance companies it is therefore well positioned to exploit different outcomes:

- Cat Bonds benefit from coupon as well as significant price appreciation during the hurricane season. Typically, September and October are the strongest months for ILS funds in a benign season.
- Equities: any hurricane season has the potential to raise volatility of insurers exposed to natural catastrophe risks. Volatility creates opportunities and the liquid insurance equity market, such as smaller reinsurance companies or Floridian homeowner insurance companies, can often see names being mispriced in both benign as well as active hurricane seasons.
- Private Debt positions with US homeowner insurers sit outside of the reinsurance programs of these firms, thereby benefitting from the reinsurance protection which has been purchased.
- Best Ideas portfolios maximise returns during the hurricane season while keeping the exposure to a large event substantially below a pure Cat Bond portfolio.

Recent market volatility, driven by geopolitical concerns and concern around rising interest rates, has created a window to re-invest in Insurance Bonds at attractive levels. The emerging market of RT1s (Restricted Tier 1 capital), as described in this Twelve Perspectives, increases this opportunity even further in our view.

Twelve Perspectives – Focus

- **US hurricane season**
- **Restricted Tier 1 (RT1) capital**

US Hurricane Season

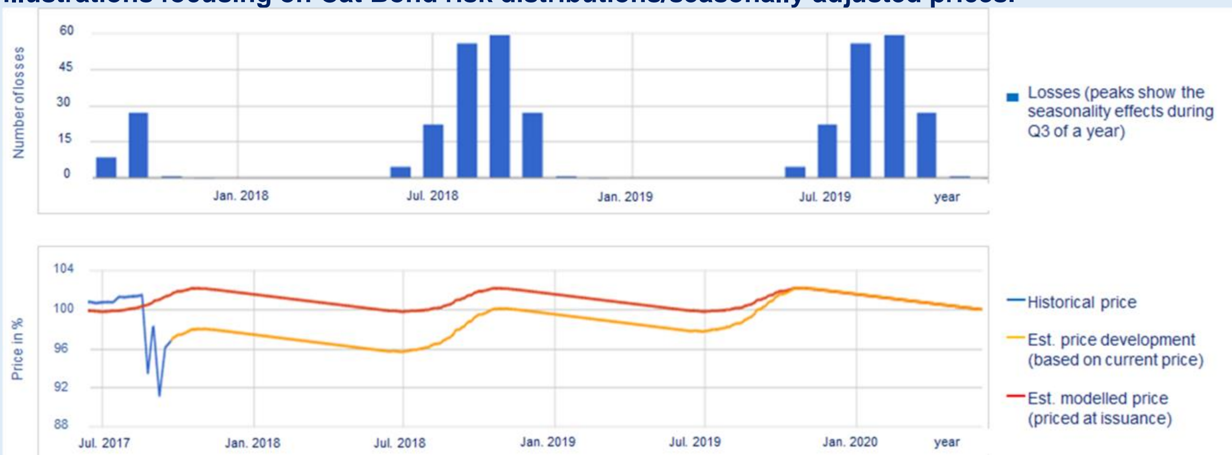
Back in 1935, the organisation which preceded the National Hurricane Center initiated the concept of hurricane season monitoring by implementing nightshifts to watch out for hurricanes. While the official start of “the season” has been moved since then from 15 June to 1 June, its purpose has not: increased vigilance in anticipation of heightened tropical storm activity.

Last year’s hurricane season and its effects on the ILS market are well remembered. In this Twelve Perspectives, we outline how seasonal exposures to tropical cyclones create investment opportunities across the balance sheet of insurance companies: in ILS, equities and debt alike.

Investment Dynamics

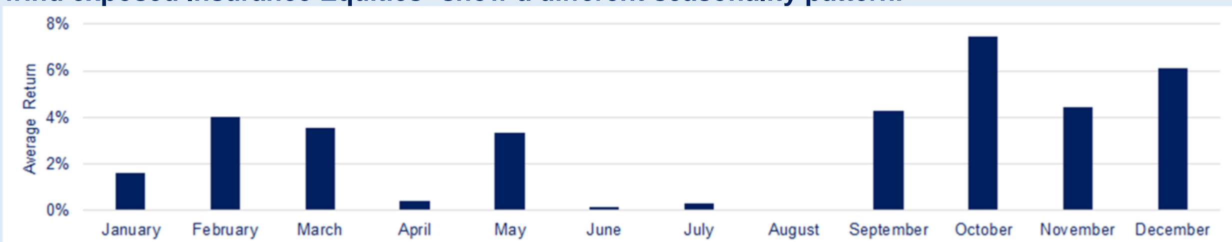
Whilst Cat Bonds covering US wind risks usually generate the majority of their returns during the hurricane season, Insurance Equities tend to outperform towards the end of this period. Following a mild wind season, expectations around special dividends and the strengthening of an insurer's balance sheet serve as the main catalysts for share price outperformance whilst, in an active season, additional trading opportunities are often created because of short-term mispricing in the market.

Cat Bonds offer increased potential returns during the hurricane season, as outlined in the below illustrations focusing on Cat Bond risk distributions/seasonally adjusted prices.



Source: Twelve Capital. As at 31 May 2018.

While US wind Cat Bonds typically generate most of their returns between June and October, US wind exposed Insurance Equities* show a different seasonality pattern.



Source: Twelve Capital, AIR & Bloomberg PORT as at 2 May 2018.
*Peer Group constituents Florida Primary's: FNHC, Heritage, UIHC, Universal.
Average monthly returns were calculated from 31 December 2008 to 1 May 2018.

The profit potential of different insurance asset classes is influenced by longer-term market cycles and shorter-term seasonal dynamics that affect valuations. Over a market cycle, there are periods when Insurance Bond coupons or Insurance Equity appreciation may help offset spread compression in Cat Bonds; or when a widening in Cat Bond spreads may compensate for lower Insurance Bond yields for instance. It is also possible to benefit from significant short-term capital appreciation in Cat Bonds during the May to November US wind season. However, regardless of each potential scenario or the specific market nuances at a particular point in time, Twelve Capital has the insurance sector knowledge to exploit these longer-running and shorter-term profit opportunities across insurance balance sheets and aims to take advantage of these for its investors.

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Scenario: "A benign North Atlantic Hurricane Season" such as 2014, 2015 and 2016

Overall Wind exposed businesses

	Non Wind-season Oct-Mar	Wind-season Apr-Sep
2018	10.4%	
2017	11.0%	-0.3%
2016	3.0%	2.4%
2015	17.6%	1.0%
2014	13.1%	5.0%
2013	18.9%	6.7%
2012	22.3%	8.7%
2011	9.6%	-16.0%
2010	2.1%	1.6%
2009	-10.4%	37.3%
2008		-15.2%
2008-18 average	9.8%	3.1%
2010-18 average	12.0%	1.1%
2012-18 average	13.8%	3.9%

Bermudians

	Non Wind-season Oct-Mar	Wind-season Apr-Sep
2018	6.6%	
2017	18.7%	-7.6%
2016	4.7%	3.0%
2015	10.3%	3.3%
2014	6.4%	4.9%
2013	21.1%	4.2%
2012	18.5%	6.5%
2011	7.0%	-17.6%
2010	3.1%	8.7%
2009	-17.0%	31.0%
2008		-3.2%
2008-18 average	7.9%	3.3%
2010-18 average	10.7%	0.7%
2012-18 average	12.3%	2.4%

Florida Primary

	Non Wind-season Oct-Mar	Wind-season Apr-Sep
2018	23.8%	
2017	-1.7%	-0.9%
2016	-5.7%	4.7%
2015	44.6%	-13.7%
2014	70.0%	25.0%
2013	17.9%	37.6%
2012	40.8%	10.8%
2011	17.9%	-13.5%
2010	-3.0%	-24.3%
2009	5.5%	16.8%
2008		-41.2%
2008-16 average	23.5%	0.3%
2008-18 average	21.0%	0.1%
2010-18 average	22.8%	3.2%
2012-18 average	27.1%	10.6%

Peer Group Constituents
Bermudians – Arch, Argo, Aspen, Axis, Everest Re, Ren Re
Florida Primary's – FNHC, Heritage, UIHC, Universal

Source: Bloomberg. As at 31 March 2018. Past performance is not indicative of future returns.
Note: Oct-Mar is Q4 from prior year and Q1 in current year.

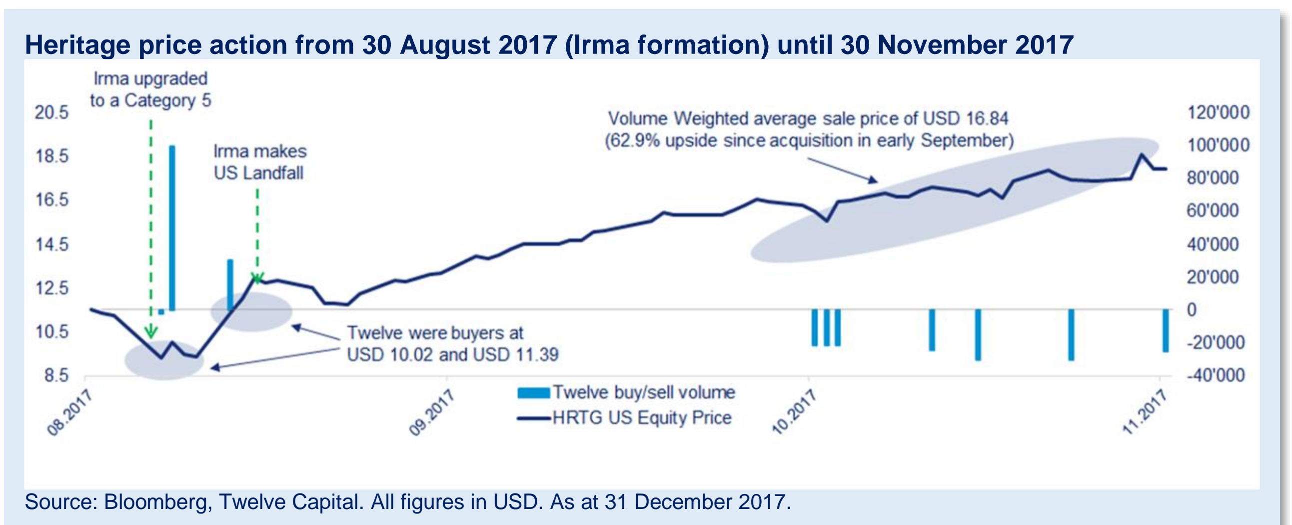
Historically, insurance companies exposed to wind risk significantly outperformed outside of the US hurricane season. These names have typically appreciated by more than 10% outside of this time.

Scenario: "An active North Atlantic Hurricane Season" such as 2017

Live hurricane events can generate substantial market uncertainty around the fair value of exposed (re)insurance stocks, providing attractive short-term investment opportunities.

Case Study: Heritage[1]

Heritage price action from 30 August 2017 (Irma formation) until 30 November 2017



Source: Bloomberg, Twelve Capital. All figures in USD. As at 31 December 2017.

– Utilising the firm's ILS expertise and deep fundamental knowledge around insurance stocks, Twelve Capital were buyers of Heritage as Irma approached the US.

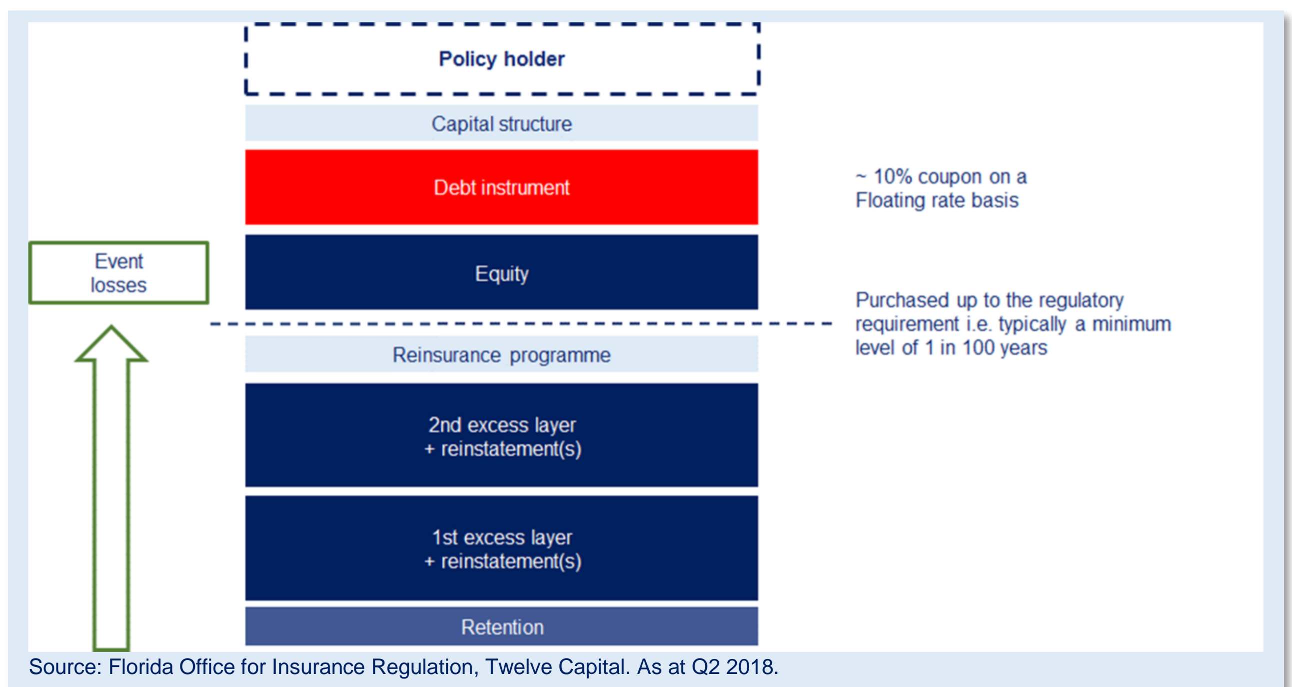
[1] Heritage Insurance Holdings, Inc. (Heritage Property & Casualty Company) is a publicly traded company listed on the New York Stock Exchange (Ticker: HRTG). The company offers home, condo, rental property and commercial residential insurance.

– Further Heritage shares were bought just prior to landfall as, in our view, the company's valuation was no longer an appropriate reflection of the (reduced) risks being faced. These purchases were made:
  – On 6 September 2017, shortly after the storm was upgraded to a category 5 hurricane,
  – On 11 September 2017, just prior to US landfall.
– Post event, Heritage shares rallied significantly, supported by the company buying back stock and due to a positive earnings outlook anticipating future rate increases for the name.

Private Debt to US Homeowner Insurers

The Twelve Insurance Private Debt strategy offers access to financing arranged with small and medium sized insurance companies across Europe and the US. In this context, and in light of the US hurricane season, this Twelve Perspectives focuses in particular on Floridian homeowner insurers.

– The Florida Office for Insurance Regulation expects insurance premiums to raise on average by 4.5% for 2018, as well as for the next four years.
– The highest increases of 10.2% p.a. are projected for areas prone to water claims litigation such as Miami-Dade county.
– In contrast, reinsurance costs for Floridian insurers, according to JLT Re's Risk-Adjusted Florida Property-Catastrophe Rate-on-Line Index, rose by only 1.2% this year.



Source: Florida Office for Insurance Regulation, Twelve Capital. As at Q2 2018.

Current Market Dynamics

– Insurers in Florida are obliged to purchase reinsurance protection for catastrophe events that have a statistical recurrence of 1:100 years (meaning the most severe events could still be greater than a company's entire reinsurance program).
– There is therefore substantial margin expansion potential for Floridian homeowner insurers, unless claims experience for those firms changes substantially.

info@twelvecapital.com
www.twelvecapital.com

The emerging Restricted Tier 1 Market for Insurance Companies

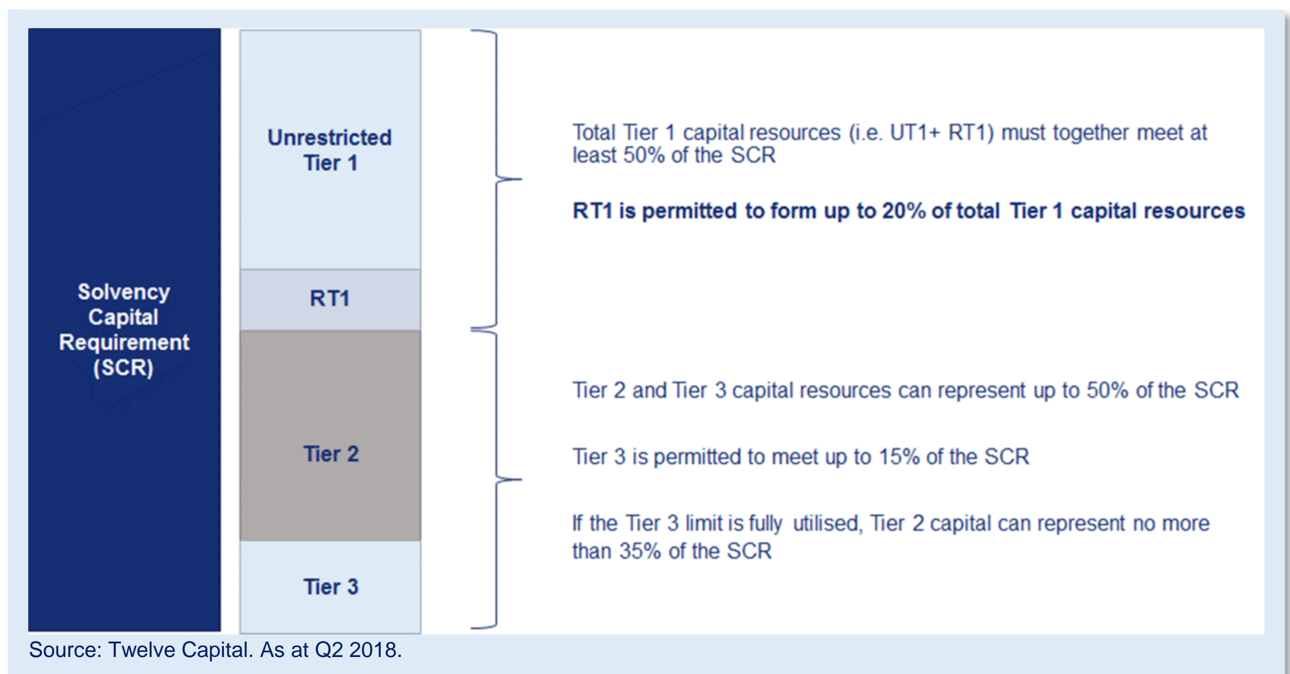
Another key theme for the insurance sector at this time, although unrelated to the hurricane season, is the emergence of Restricted Tier 1 (RT1) instruments for insurance companies. Bank AT1[2] bonds emerged a short time after the financial crisis, with initial structures coming to the market in 2009. These hybrid instruments have grown in popularity and assist banks to meet their Basel III capital requirements. In turn, they have proven attractive for many investors who benefit from higher coupons given the hybrid nature of the instrument (which could, for instance, be converted into equity in times of distress). The outstanding level of issuance has exceeded USD 200bn at this time, and AT1s have become a mainstream investment across many credit funds.

RT1

- **Restricted Tier 1 ("RT1") is a form of insurance regulatory capital defined within the Solvency II framework.**
- **By design, it is intended to be high quality capital, supporting insurance groups as going concerns.**
- **RT1 comes second only to equity (referred to as "Unrestricted Tier 1" or "UT1" under Solvency II) in terms of capital quality for an insurer, sitting next to it on our "Debt-Equity Continuum" (illustrated further below).**

Issuance of equivalent instruments for insurance companies has only recently begun to evolve, with RT1s first categorised under the Solvency II regulatory regime. Despite RT1s sharing certain attributes with AT1s, investors should be cognisant of the fact that there are fundamental differences between banks and insurance companies as well as in terms of the triggers and features of these instruments.

In support of its regulatory objectives, Solvency II imposes minimum capital quality standards for insurers and, to meet a firm's Solvency Capital Requirement (SCR), the use of RT1s can form up to 20% of total Tier 1 capital resources with total Tier 1 capital resources having to cover at least 50% of an insurer's SCR.



Source: Twelve Capital. As at Q2 2018.

[2] Additional Tier 1.

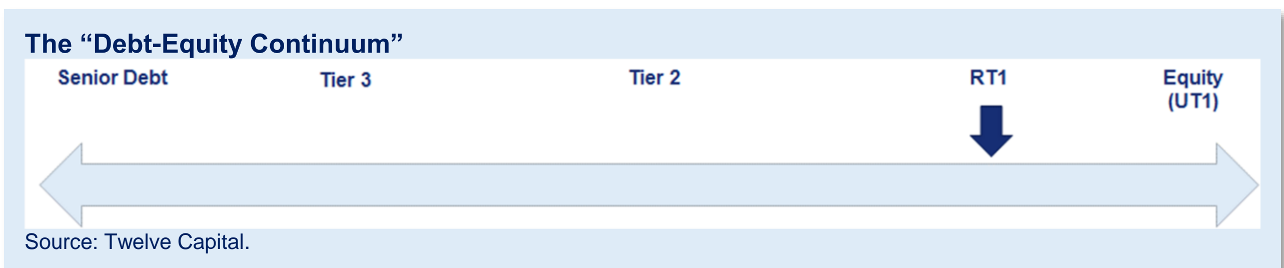
With larger insurers such as RSA Insurance Group, Scor and ASR Nederland issuing their inaugural RT1 bonds during 2017 and 2018, a number of their peers are likely to have similar programs going forward in order to utilise this new form of solvency capital financing.

Core Terms	ASR Nederland	Direct Line	Phoenix	SCOR
Country	Netherlands	UK	UK	France
Subordination	Senior only to equity	Senior only to equity	Senior only to equity	Senior only to equity
Maturity/First Call	Perpetual/ October 2027	Perpetual/ December 2027	Perpetual/ April 2028	Perpetual/ March 2029
Non payment of interest	Freely cancellable any time, MCR* or SCR** breach mandatory	Freely cancellable any time, MCR or SCR breach mandatory	Freely cancellable any time, MCR or SCR breach mandatory	Freely cancellable any time, MCR or SCR breach mandatory
Arrears settlement	N/A - non-cumulative	N/A - non-cumulative	N/A - non-cumulative	N/A - non-cumulative
Suspension of repayment	Upon breach of MCR or SCR	Upon breach of MCR or SCR	Upon breach of MCR or SCR	Upon breach of MCR or SCR
Going concern principal loss absorption	Full permanent share conversion at ~30% discount to market price on pricing date	Full permanent share conversion at ~30% discount to market price on pricing date	Full and permanent write down (in whole)	Full or partial write down. Reinstatement subject to relevant rules.
Size	EUR 300m	GBP 350m	GBP 500m	USD 625m
Coupon	4.625%	4.75%	5.75%	5.25%
Moody's/S&P/Fitch	NR/BB-	Ba1/BB	NR/NR/BBB-	Baa1/A-

Source: Twelve Capital. As at 30 June 2018. *MCR: Minimum Capital Requirement, **SCR: Solvency Capital Requirement.

Historically, the development of the RT1 market had been held back by tax and regulatory uncertainties, together with generous transition arrangements which made the need for RT1 issuance less pressing. However, as grandfathering provisions come to an end and as RT1 coupon levels remain competitive to grandfathered instruments which were issued prior to the inception of Solvency II, the greater the likelihood is that this new market will continue to grow. The potential size of the market is substantial, as RT1 is permitted to form up to 20% of total Tier 1 capital.

The "Debt-Equity Continuum"



Source: Twelve Capital.

Are all RT1s the same?

Differences in tax regimes across member states and interpretation of Solvency II rules by local regulators has led to material differences between RT1s issued in the market to date.

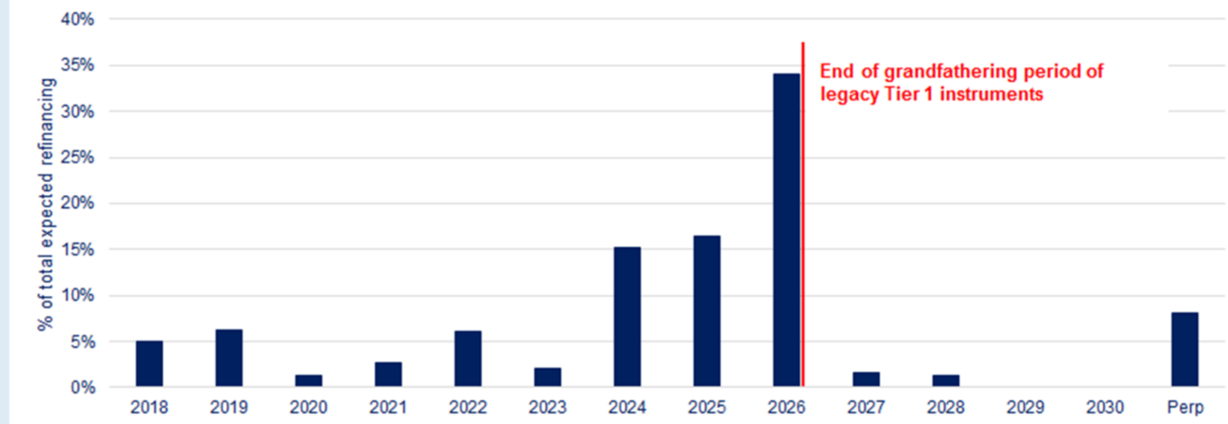
What is the potential size of the European Insurance RT1 Market?

Analysing the capital structures of 48 insurers across the UK (18) and Continental Europe (30), Twelve Capital found that:

- Currently there are about EUR 43bn of RT1 classified instruments outstanding in the market; about EUR 41bn of these are included by virtue of grandfathering and will therefore need to be refinanced by 2026 at the latest to meet Solvency II standards.

– Furthermore, there is plenty of scope for the market to develop. If RT1 limits were to be used to their full extent, the amount of issuance in the marketplace would stand at more than EUR 110bn. Assuming a 50% limit utilisation, these instruments could reasonably make up around EUR 55bn of the market (compared to the bank AT1 space which has an estimated EUR 150bn+ of outstanding issuance).[3]

Existing RT1s - Expected Refinancing Schedule

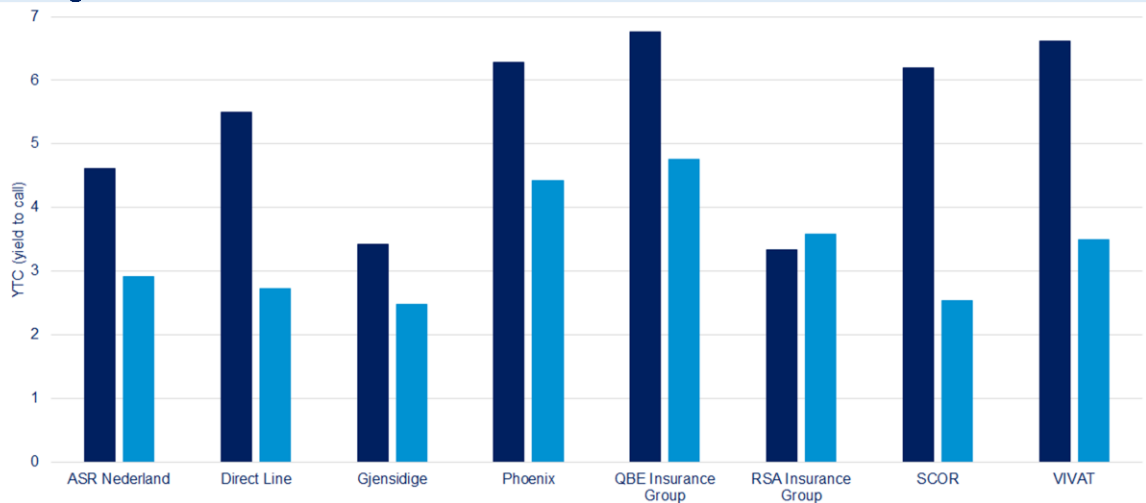


Source: Bloomberg, Twelve Capital. As at Q1 2018.

The additional Yield Pick Up is compelling

When comparing Tier 2 bonds with RT1s from the same issuer, there is a meaningful pick up in spread/yield which makes a compelling case for investing in RT1 hybrid instruments in our view. On average, there is a minimum pick up of approximately 195bps.

Average Yield to Call



Source: Bloomberg, Twelve Capital. As at 27 June 2018.

[3] Source: Twelve Capital. As at 30 June 2018.

Key Features

While each bond has specific features described in its prospectus, in accordance with the Solvency II framework, typical RT1s will automatically convert into equity or be written down upon three events:

1. A breach of the SCR for more than three months;
2. A drop in an insurer's solvency ratio below 75% of the SCR;
3. A breach of the MCR.

Benefits for Issuers

Market conditions, increased confidence in the industry	– Issuance has been significantly driven by current market conditions, with some issuers in particular taking advantage of reduced spreads across certain markets. – The potential universe of investors has grown significantly and these investors are extremely receptive to RT1 instruments. – The ultra-low yield environment persists.
Capital management	– Shareholders have been receptive to RT1 issuance for those structures that feature equity conversion. – There is an acceptance from investors for insurance companies to rely on a broader spectrum of capital, therefore ensuring there is greater flexibility in the quality of that capital. – Large insurers such as AEGON have achieved shareholder approval to issue up to EUR 5bn of RT1 capital over the next 5 years, to replace grandfathered Tier 1 instruments.
Improving capital strength	– For issuers, RT1s are immediately included in Solvency II calculations and can form up to 20% of Tier 1 capital. – Issuers are also taking advantage and pre-empting the end of the Solvency II grandfathering period.
Structural benefits	– For issuers, the RT1 structure provides material benefits; similar to Bank AT1s, RT1 bonds are loss-absorbing instruments. For issuers, they offer the benefit of being a source of permanent capital if needed, perpetual in nature, with non-step coupons (i.e. the lack of step-up does not accelerate further downside when not called) and reducing refinancing risks. – Fully discretionary and non-cumulative coupons.

Source: Twelve Capital. As at 30 June 2018.

Twelve Capital AG
Dufourstrasse 101
8008 Zurich, Switzerland
Phone +41 (0)44 5000 120

Twelve Capital (UK) Ltd
Moss House, 15-16 Brook's Mews
London W1K 4DS, United Kingdom
Phone +44 (0)203 856 6760

Twelve Capital US Inc.
1010 Northern Blvd, Suite 208
Great Neck, NY 10021
United States of America

info@twelvecapital.com
www.twelvecapital.com

About Twelve Capital

Twelve Capital is an independent investment manager specialising in insurance investments for institutional clients. Twelve Capital's investment expertise covers the entire balance sheet of insurance companies, including Insurance Bonds, Insurance Private Debt, Catastrophe Bonds, Private Insurance-Linked Securities and Insurance Equities. The firm also structures portfolios of its Best Ideas. Twelve Capital was founded in October 2010 and has offices in Zurich, London and New York.

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