

Pensions: Buy out - sell out

If investing in an insurance business, be very afraid of rapid growth.

Suspended disbelief

An insurance company receives premiums now and pays claims later. Once the premiums come in then only two balance sheet items prevent them from going to profit: unearned premium reserve and loss reserves.

The accounting rules for determining unearned premium reserve are relatively fixed. However reserve evaluation is very much at the discretion of the company. It is therefore possible for short term premium growth to be translated into short term profit growth in an insurance company.

However, as many insurers have discovered, those initial reserve estimates can be low and deteriorate over time. Persistent, continual reserve strengthening over many years has been the death knell of many an insurer. In fact only a few survive the experience. BRAVE Partners' friends at Novae in the Lloyds market are one notable survivors where the current management has done an outstanding job of containing and withstanding the losses in their financial institutions' professional indemnity books.

Growing pains

The BRAVE partners often joke that it is easy to get into the retrocession (reinsurance of reinsurance) business. All you need to do is to make a sandwich board emblazoned with the sign: "I write retro" and walk up and down Lime Street outside the Lloyds building.

By lunchtime on the first day you will have a pretty sizeable book of business and with some aggressive reserving, the profits might look pretty good. Growth rates would have been phenomenal. However, as many a Lloyds name found out, the profits can be short lived.

Another classic example of phenomenal growth gone bad is life reinsurance business, Scottish Re. Rumour was that for a while Scottish Re were pricing at about a 10% discount to the market. Certainly the firm won a lot of business from competitors during its period of operation. However, skeletons began to drop out of the wardrobe and soon the profits got swamped in reserve strengthening and turned to losses. Scottish Re folded, taking a capital injection from two financial investors with it on the way out.

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Insurance buy out business

BRAVE Partners read with interest the owner's comments that Insurance Pensions Solutions is considering an IPO in 2010. The main reason cited for an IPO of the business is the fact that increasing pension deficits will lead to increasing demand for buy outs and the business will need the type of capital that only a public company can raise. Insurance Pensions Solutions is perhaps the last man standing of the swathe of pension buy out businesses that were started shortly after the sharp stock market fall. In the commentary "Bye bye", BRAVE Partners analyses the demise of the pensions buy out business.

Insurance Pensions Solutions has to be respected as practically the sole survivor in the space. Their founder, Edmund Truell, is clearly a winner with a great track record and the business sports some impressive investors, such as the JC Flowers funds. However, there is doubt at BRAVE Partners over the long term viability of the annuity buy out business.

In particular BRAVE Partners actually believes that the current environment is detrimental to pension buy outs.

Liquidity squeeze

The accounting deficit on a pension is usually calculated from a more moderate set of assumptions than the assumptions that an insurer would use to calculate the buy out price for a scheme. In short, at a buy out valuation pension deficits are almost invariably larger. A company with a pension deficit has one of two paths open to it:

1. Sell the scheme to a buy out company.
2. Agree a contribution schedule with the trustees to meet the minimum funding requirement.

The second option is almost invariably cheaper and less of a cash strain on the sponsor, but it does mean that the sponsor retains the risk. However, as deficits rise, the second option becomes more attractive and liquidity is in short supply, the second option is more attractive. A full buy out (option 1) requires the company to produce in immediate cash, the larger buy out deficit. The second option (filling the deficit on an agreed schedule) allows the sponsor to pay the smaller Pensions Act deficit over a period of time agreed with the pension trustees. If a company is preserving cash because financing is expensive, then a buy out is not attractive.

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Caveat emptor

Insurance Pensions Solutions has a great founder and an impressive set of investors. The business must have done something (or more likely many things) right in order to be practically the sole survivor out of its carder. However, BRAVE Partners believes that the pension fund buy out market will be getting tougher. Solvency II does not favour UK style annuity books. Companies will be less able to pay up, so pricing will be under pressure even for a near monopoly. An investor that is attracted to Insurance

Pension Solutions stock on the basis of huge growth potential needs to think long and hard about the margin at which the growth is achieved. As a college friend of one of the BRAVE Partners once said whilst trying to sell T-shirt sporting a picture of a class mate at a party: "The best thing that can happen is that I sell all of them, then I only lose £30."

To be clear, BRAVE Partners is not suggesting that an IPO in Insurance Pension Solutions would necessarily be a bad choice. The business has a lot going for it. The firm does however wish to suggest that potential investors concentrate more on margin than on growth.

BRAVE Partners Services

BRAVE Partners LLP has a deep understanding of insurance business. The firm can advise clients on the salient issues when evaluating the potential of insurance companies. Insurance companies operate in a markedly different way to corporate and even banks. It is important to understand these nuances, otherwise an investor can make ill-informed, possibly bad, choices.

- *The UK pensions buy out industry is under pressure.*
- *BRAVE Partners suggest that investors take care in assessing the prospects for an insurance business that is considering an IPO.*
- *BRAVE Partners LLP can assist investors seeking to diversify into insurance businesses and risks to understand the important dynamics and nuances of the sector. This can make the difference between outstanding success and outstanding failure.*

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