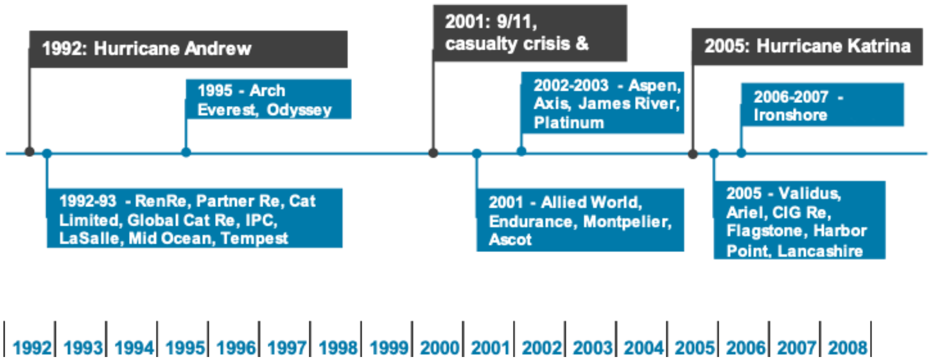
Bermuda Q1 Wrap: Suddenly More to "Prove"

(Re)insurance Capital Formations – 1992 – 2007



The defining characteristic of the Covid-19 crisis—for (re)insurance markets and the world more broadly—is the high degree of uncertainty around what the implications of the still unfolding crisis.

It is unclear how quickly the economy will rebound, the full scope of losses the industry is facing, or how profoundly the "work from home" culture will become an impetus towards greater cost and technological efficiency.

How the crisis plays out in the coming months will figure heavily into whether the "survival of the fittest" imperative that has predominated in the Bermuda market for the last 10+ years will intensify. We think it will.

As has been the case for much of its history – and even before the ongoing pandemic disrupted the status quo – the Bermuda (re)insurance market has been in a state of flux in recent years.

The inflow of alternative capital, cheaper market pricing, and a sustained level of excess capacity had disrupted the business model for a group of companies founded upon attractive, market-timed opportunities in the property cat market – and which had been in the process of pivoting to become diversified specialty (re)insurers.

The raison d'etre of many such under-sized, subscale companies had outlived the opportunities upon which they had been founded, such as in the weeks and months after Hurricane Andrew, the WTC attacks, and Hurricane Katrina.

Many of the underwriters started in the aftermath of those events are no longer around as standalone companies, and those that have survived have had mixed levels of success in hitting the critical mass required to have relevance to distribution and in delivering adequate returns to shareholders.

We wrote in early March that 2020 would likely be a "prove-it" year for the remaining Bermuda independents. And suddenly these companies have much more to prove in a much more challenging operating environment that is likely to generate winners and losers.

At a time when "capital is scarce and risk is abundant", the business strategies of existing companies will be put to the test.

We've written before about the well-documented challenges at **Axis**, where scale and solid underwriting fundamentals have remained challenges—and that all things considered, **RenRe**, **Everest**, and **Arch** were better positioned to capture share in a "transitioning" market.

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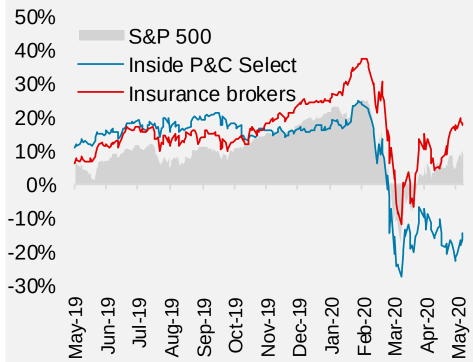
Composite	YTD px chg.	P/B
Large comm.	(33.3)%	0.8x
Regional	(37.4)%	1.2x
Specialty	(26.7)%	1.5x
Personal	(7.0)%	1.9x
Bermuda	(28.4)%	1.1x
Florida	(26.8)%	1.0x
Brokers	(5.1)%	-
IPC Select	(26.6)%	1.0x
S&P 500 Fin.	(28.7)%	-
S&P 500	(8.7)%	-

Top performer on the day	CB +8.1%
Bottom performer on the day	UIHC -5.6%

1YR Price Peformance



Still, for any of these companies, the words uttered by Sompo International chairman John Charman during Endurance's takeover battle with Aspen ring evermore true today:

> *"The world is moving quickly and competition is fierce; it's survival of the fittest. The global insurance and reinsurance business is overpopulated and the law of the jungle is already operating."*

We think that the likelihood of even greater change – including further consolidation among incumbents and potentially new capital formation – in the Bermuda market is on the rise as it is impacted by:

- a stronger outlook for (re)insurance market conditions
- accelerating scale among brokers
- an uncertain economic landscape
- a mounting level of activism in the space
- a moment where the necessity of cost efficiencies has been magnified by the crisis

Exhibit: IPC Bermuda Composite Earnings Summary

Source: SNL, Company Reports, Inside P&C

($mn)	IPC Bermuda Composite		
	Q1:19	Q1:20	YoY var.
GWP	7,899	9,358	18.5%
NWP	5,630	6,776	20.4%
NWP/GWP	71.3%	72.4%	1.1pts
Loss ratio	58.8%	72.6%	13.9pts
Acquisiton ratio	21.1%	20.5%	(0.6)pts
Op. expense ratio	10.0%	9.5%	(0.5)pts
Combined ratio	89.9%	102.5%	12.7pts
Cats	1.0%	8.5%	7.4pts
PYD	(0.5%)	(0.1%)	0.4pts
Ex. cat. AY CR	89.3%	94.2%	4.9pts
U/W gain, P/T	449.1	(141.7)	NM
NII, P/T	451.0	453.4	0.5%
ROE (annualized)	11.1%	7.2%	(3.9)pts

Includes: ACGL, AXS, RE, and RNR

Bermuda Q1 wrap

While for more than the last two months the industry's attention has been captured by the ongoing pandemic, there had already been many other forces at work that the Covid crisis has since intensified.

It is becoming an increasingly common talking point that the fallout from the outbreak and corresponding economic shutdown will serve only to accelerate existing trends in the market, including the movement towards firming market conditions, increased levels of consolidation, and a greater urgency to adopt more cost efficient strategies, such as the more effective utilization of technology.

While these developments are sure to exert influence on the broader industry, their impact is much more likely to be acutely felt in the Bermuda market, an industry sub-segment that is more prone to rapid change.

Previously in times of dislocation within P&C, all eyes would turn to Bermuda.

The island is famous for having spawned a new wave of entrants after other pivotal loss events, such as the capital that came into the business following Hurricane Andrew, the WTC attacks, and Hurricane Katrina.

Since that time, a great deal has changed.

History has exposed the limited ability of companies founded after these events to extend their shelf-life as globally-focused diversified specialty companies.

More companies started in the aftermath of Hurricane Katrina came up short in efforts rather than succeeding, unless success is defined by shareholder gains from sales to larger industry players. **(See Allied World, Endurance, and Validus)**.

Longer-term returns have been disappointing and the benefits of scale reaped by larger-sized incumbents, as well as those who sold at the peak of the last M&A cycle, have become more apparent.

Even more critically, those who opted for a "go-it-alone" approach have been stuck in neutral - with some exceptions - and in many cases plagued by underwriting challenges that have stemmed in part from the attempt to achieve scale by growing quickly in a soft market.

Axis has perhaps received more attention than most – partially owing to its size and prominence - but other Bermuda names now also find their longer-term future more acutely in doubt.

Sirius, whose history goes back much further, is now in the final stages of a bidding process. Argo has experienced a series of pitfalls that some have speculated will ultimately lead to a sale. Greenlight Re ran a full sale process which it ultimately pulled after failing to secure its target valuation. And Watford, too, is now in the crosshairs of an activist investor.

RenRe, Arch, and Everest, it is oft-noted, are much more strongly positioned, with the attendant advantages of bigger balance sheets, increasingly diversified platforms, and management teams who have more adeptly managed the cycle.

But even at these formidable businesses there are challenges.

Arch has accrued meaningful exposure to what could be a foundering mortgage market—contingent upon the totality and duration of the economic shutdowns—while RenRe scaled up its casualty book more quickly than any other reinsurer in the period between 2014 and 2019, both organically and through M&A.

Still, in a changing landscape, it is perhaps those best positioned that have the most to gain by taking bold steps to solidify their market standing and perpetuate competitive advantages into the future.

The degree of recent consolidation among major broking houses, the uncertainty of market conditions arising from the pandemic, as well as mounting pressure from stakeholders, have all made the urgency for strategic action all the more imperative.

Consolidation often comes quickly, with decisions often made as much out of instinct as they are based on cold, hard reasoning.

At a time when fear over the future is pervasive, a sudden moment of existential questioning may move the market more quickly into a direction that it had been trending towards already.

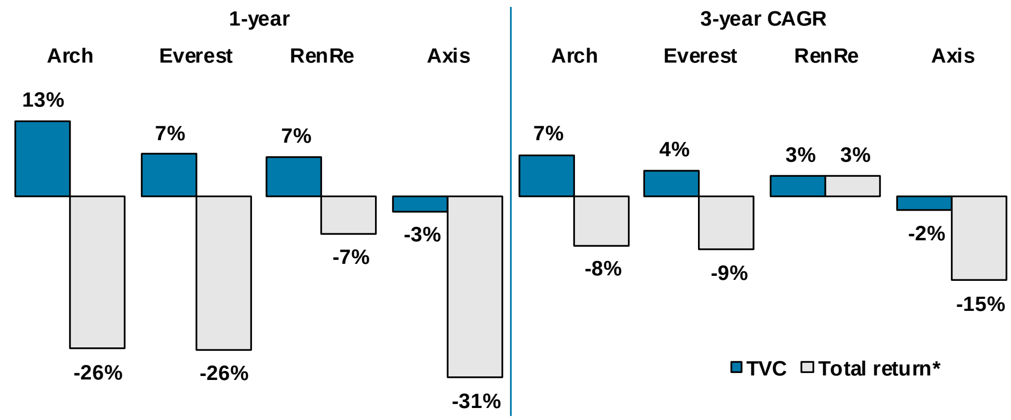
Bermuda Q1:20 Earnings Summary

- ***Bermuda GWP growth accelerates in Q1:20 to 21% from 15% in Q4:19***
- ***Reported CR rises +~13pts off ~$575mn in reported Covid-19 claims***
- ***Ex-Cat AY CR +4.9pts; improvements at Axis and Arch outweighed by "attritional" Covid-19 losses at Everest, RenRe***
- ***Double-digit rate increases reported across most lines***
- ***Reserve releases continue to slow (↓~67% YoY)***
- ***NII falls ~10% from Q4:19 to $451mn due to lower yields***

TVC -16% IN Q1 = COVID-19 LOSSES WIPE OUT GAINS

Exhibit: TVC and Total Returns

Source: SNL, Company Reports, Inside P&C



**End date reference point for total return is May 8, 2020 – one day following the last peer earnings release*

As we've written before, winning in the (re)insurance industry is generally defined as compounded total value creation over time, calculated as tangible book value growth plus capital return to shareholders as dividends.

In addition, winning also entails "avoiding the zeroes" that result in significant dilutions to book value - such as over-priced acquisitions, outsized losses, or significant trends of under-pricing business through a prolonged soft market.

Total value creation turned negative in the first quarter as sizeable Covid-related (re)insurance and financial market losses delivered a hit to profitability.

All four companies in our composite registered total value erosion in the quarter, following strong gains in 2019. Arch and RenRe fared better, with annualized drops in value of -4.8% and -10.1%, respectively, as underwriting profitability held up better than at peers Everest and Axis.

Axis was an outlier among the group, experiencing a decline of -38.8%, as non-Covid related cats came in notably higher, and compared with the -13.8% drop at Everest.

The composite's TVC loss, or "value destruction" for the quarter of -16% compared negatively to positive valuation creation of 29% in Q1:19. The first quarter heavy "cat" losses represented something of an outlier for the Bermuda companies, where large-scale, volatile cat events are a more common occurrence in the back-half of the year.

The opening months' results mark an inauspicious start to 2020, with challenges expected to continue for the remainder of the year.

For perspective, all four companies were “in the green” to begin 2019. The level of valuation creation at Arch (+29.8%), Everest (+28.5%), RenRe (+27.9%), and Axis (+26.8%) were more broadly consistent within the composite in the year-ago quarter.

PREMIUMS ↑ 21% FOR Q1 WITH GROWTH CONTINUING TO ACCELERATE FROM RATE, SUBMISSION FLOW, M&A

Pace of Rate Strengthening Continues

Where the theme of accelerating price improvements was the dominant story of 2019, the same trends continued into the first quarter of 2020 unabated.

For some time, executives at Bermuda underwriters have been reluctant to use the “H” word to describe market conditions, expressing cautious optimism that the direction of travel would continue, and preferring to describe the environment as in “transition”.

As the economic fallout from the Covid crisis began to set in, for a brief moment, there were questions about whether the momentum of the underwriting cycle would be paused.

As the dust has started to settle, there is a much greater sense that the level of risk appetites among buyers has diminished, and that firming conditions are only likely to strengthen.

The hallmark of any “hard market” is one where capacity is in short supply and deals can’t get placed at virtually any price. We are not there yet, except in isolated instances.

But we are anecdotally hearing about an increasing number of deals where brokers have gone back to underwriters with the message: “name your price”.

Market Conditions

- **Argo.** Rate increases in the US were consistent with Q4:19 (avg. rates up in the mid- single digits); Professional and Property increases were “standouts” with “mid-teen” improvements. Submission growth remained at nearly 20% in Argo’s “core growth” businesses, while terms and conditions tightened, and some clients began taking higher retentions. Rate increases in International averaged at “around” 10% for the quarter, compared with “mid-teen” rate improvements in Q4:19.
- **RenRe.** RenRe was more optimistic on pricing than the company has been in some time, and was especially bullish in its forward-looking outlook. After noting how at the 1 January renewals that the U-shaped pricing curve remained intact, the reinsurance specialist reported estimated rate gains of 30-60% for Japanese wind renewals—amounting to a 50% expected increase in profitability, the company said—while Japanese earthquake business was roughly flat. Especially noteworthy—and in contrast to comments from peers—management expressed a high degree of confidence that the company has been achieving rate in excess of trend in casualty segments.

Exhibit: Axis pricing disclosures

Source: Axis conference call

	Q4:19	Q1:20
All-In	11%	10%
US Programs	14%	15%
Excess Casualty	24%	20%
Excess Property	16%	15%
US Programs	6%	5%
NA Professional	7%	7%
Global Cyber & Tech	1%	1%
Commercial Mgmt Solutions	17%	17%
Public D&O	NA	40%
Private D&O	NA	25%
Axis Bermuda	"double-digit"	18%
Canadian Specialty	"double-digit"	"double-digit"
London	12%	8%

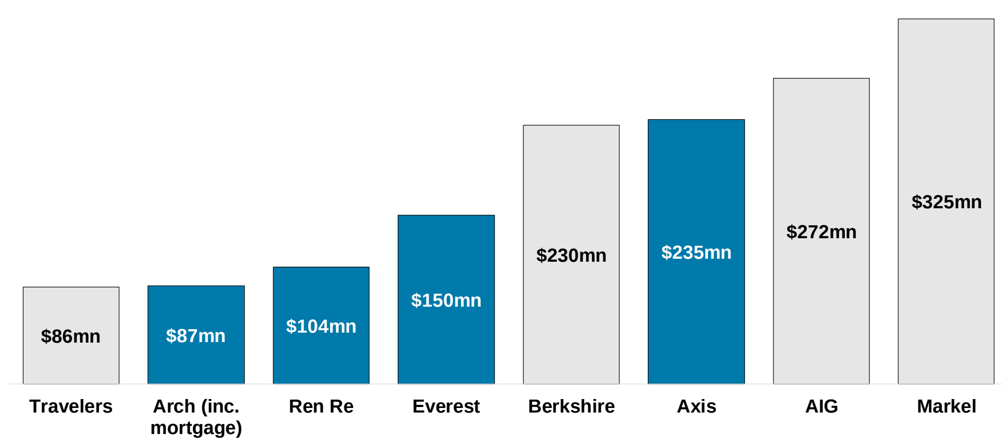
COVID-19 CLAIMS CAUSE "CAT LOSSES" TO CLIMB SHARPLY

From a "cat loss" standpoint, the first quarter was easily one of the most unusual in recent memory. Most companies around the industry reported expected Covid-19 losses as cat losses, though some—Everest and RenRe included—elected to report these losses on an attritional basis.

For clarity, we are reporting the scope of each company's Covid-19 losses here.

Exhibit: Covid-19 Loss Estimates

Source: Company reports, Inside P&C



As with the rest of the industry, the focal point for Covid-19 losses has been Property BI exposure and event cancellation business.

Since the crisis began, a meaningful level of business has renewed in both the primary and reinsurance markets, where (re)insurers have moved quickly to limit exposure through much more explicit virus/pandemic wordings.

Reserving for the loss given the high degree of uncertainty has been extremely challenging, with Covid-19 essentially an ongoing cat loss that has required companies to work from expected scenarios or to estimate losses up to a specific date.

For reinsurers, the picture regarding the full extent of losses is even cloudier than it is for primary companies, as reinsurance underwriters are assuming risk that spans a broad multitude of primary coverage forms and a high degree of variation across reinsurance fac and treaty contracts.

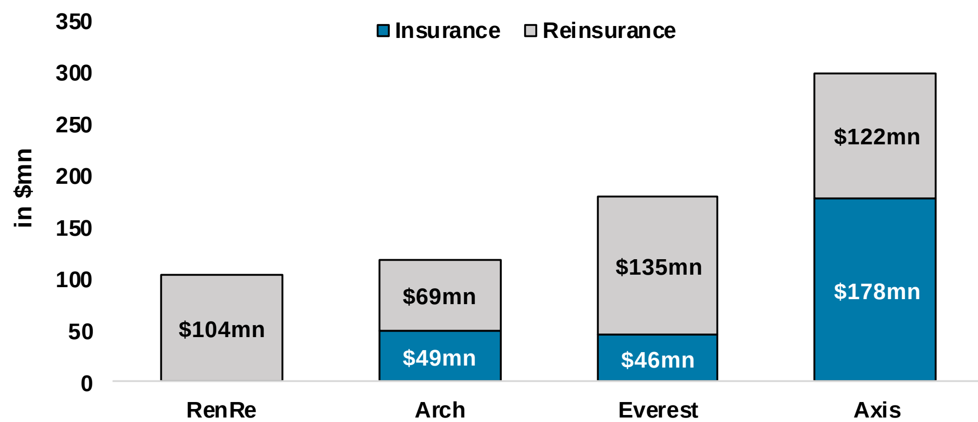
The lag on loss estimates for primary companies in evaluating their losses is already likely to be great, as much time will likely be needed for insureds themselves to evaluate the full extent of their losses, on top of the length of time that will be needed to settle claim disputes.

Most carriers stated that virus exclusions or the absence of physical damage provides immediate clarity on potential exposure, but as has been widely broadcast in the media, many insureds feel differently.

RenRe has stood out for reserving the bulk of its Covid-19 exposure in its casualty and specialty segment, with minimal reserves—none to our knowledge—currently held in its property book.

Exhibit: Bermuda Q1:20 Cat Losses by Segment including Covid-19 losses (in $mn)

Source: Company Reports, Inside P&C



Q1: Heavier Cat Quarter Than Usual

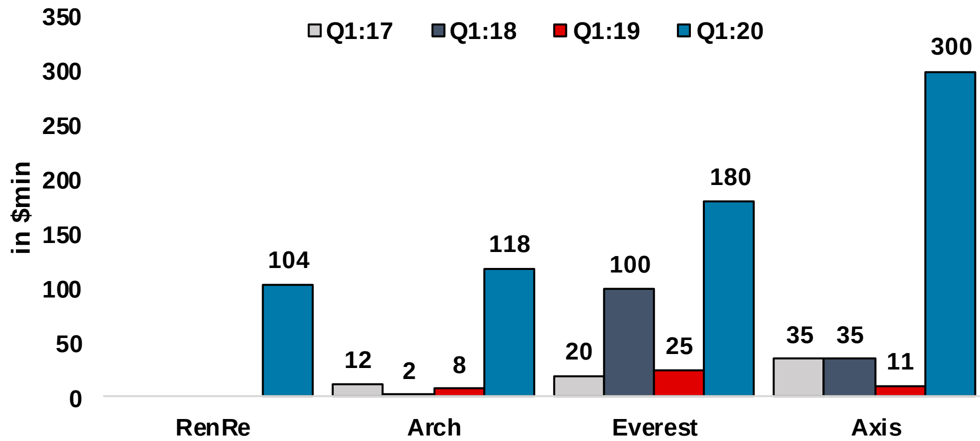
With the exception of occasional springtime wind and hail events, the first quarter is often the quietest period for cat losses of the year, suggesting an uphill climb for companies towards profitability for year, especially when factoring in the "above average" wind season from forecasters are predicting, and assuming the inevitable posting of additional loss reserves for Covid-19 in subsequent quarters.

For perspective, the $300mn in cat losses Axis registered in the first quarter is almost equivalent to its $336mn cat load for all of 2019. Axis' Covid-19 loss estimate, unlike most peers, contemplates losses in the event the global economic shut down remains in place until 31 July.

Outside of Covid-19, "traditional" cat losses also increased, primarily owing to the severe outbreak of tornadoes in early March. Axis saw the biggest jump in cat losses YoY, rising to $65mn vs. $11mn in Q1:19.

Exhibit: Bermuda Q1 Cat Losses including Covid-19 losses (in $mn)

Source: Company Reports, Inside P&C

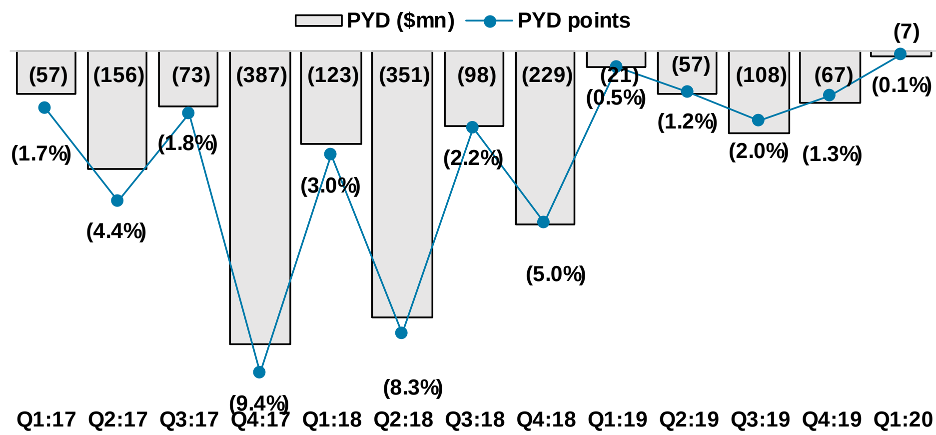


Note: RNR only reports "material" cat loss events

FAVORABLE DEVELOPMENT CONTINUES TO DECLINE ↓ 67% IN Q1

Exhibit: Bermuda Composite Reserve Development since 1Q17

Source: Company Reports, Inside P&C



Prior year loss reserve releases in Q1:20 totalled $7M, a drop from the $21M released in Q1:19 and the $108M released in Q3:19. The favourable impact on the C. ratio was.1pt, down marginally from the .5pt benefit last year.

Arch, Everest, and Axis continued to maintain a positive trend of favourable development, while prior-year losses turned adverse at RenRe. The $15mn reserve charge at Ren mostly stemmed from a deterioration in attritional loss experience in Ren's "other property segment".

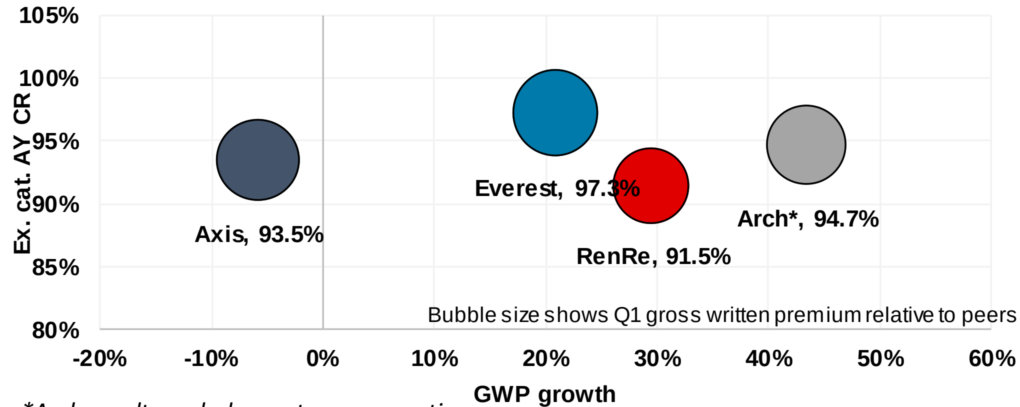
Arch saw steepest drop in favourable development (releasing $12M, down from $36M the year before), owing mostly to a decline in favourable development within the mortgage segment. Reserve activity at Axis and Everest was largely unchanged.

For reference, in 2019 releases for the composite amounted to $331M, a sharp fall from the $908M released in 2018, or roughly a ~64% reduction.

EX-CAT AY CR WORSENS IN Q1:20; IMPROVEMENTS AT ARCH, AXIS OUTWEIGHED BY "ATTRITIONAL" COVID-19 LOSSES AT EVEREST, RNR

Exhibit: Bermuda Q1 Underlying CR vs. GWP Growth

Source: Company Reports, Inside P&C



**Arch results exclude mortgage operations*

The composite's **ex-cat AY combined ratio** worsened by 4.9pts on the quarter, mostly in connection with Everest and Ren reporting Covid-19 losses on an attritional basis.

Outside of the Covid losses, the headline from the quarter was continued improvement of core underwriting margins at Axis.

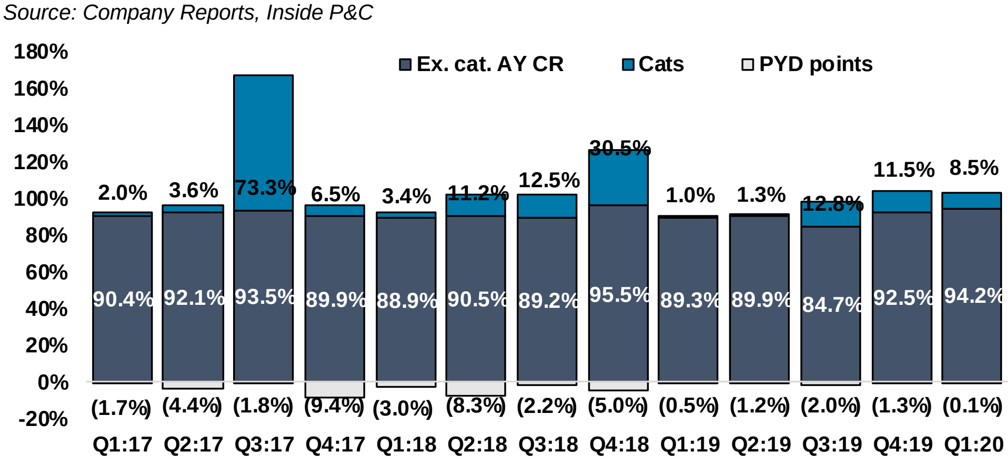
The company's underlying combined ratio improved markedly, dropping a total of 3.8pts to 93.8%, primarily from the "repositioning" of both the insurance and reinsurance segment portfolios and exiting a number of product lines.

For Axis, the rate of improvement was even stronger in insurance, where the ex-cat AY CR improved by 4.2pts to 92.2%, compared with the 2.2pt betterment in reinsurance, to 89.6%.

RenRe's casualty and specialty segment bore the brunt of Covid-19 losses—largely comprised of IBNR—adding 18.1pts to the segment's combined ratio from the year prior. RenRe did not disclose the scope of Covid-19 losses impacting its property segment.

Exhibit: Bermuda Composite Combined Ratio Contributions

Source: Company Reports, Inside P&C

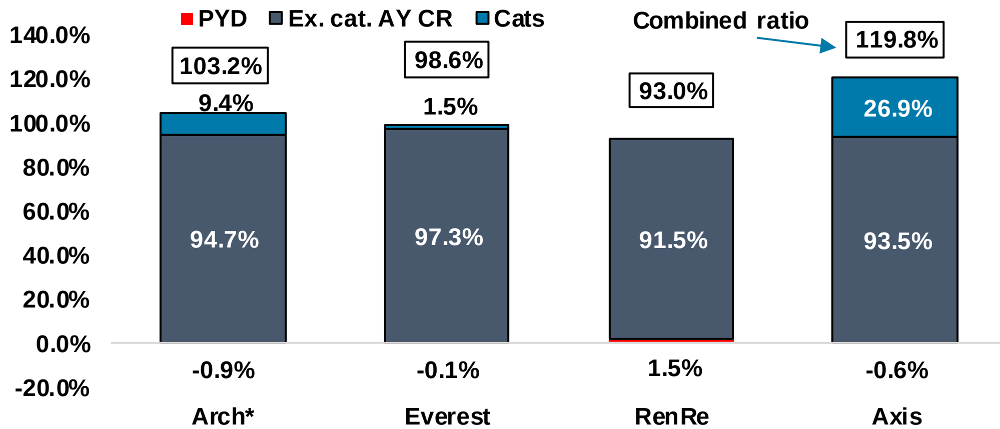


Excluding a 7.4pt impact from Covid losses, Everest's underlying combined ratio still increased to 89.9% from 87.4% in Q1:19, a deterioration the company attributed to "mix shift" towards more pro rata business in the reinsurance segment where the business will gain increased exposure to original rate rises.

At Arch, excluding the impact of mortgage—where the combined ratio jumped by 9pts to 45.9% due the expected impact from Covid-19—the ex-cat AY CR improved to 94.7%, as the insurance segment's underlying CR was better by 3.1pts (to 97.1%), while the reinsurance segment was better by 1.1pts to 91.3%, in both instances driven by earned rate increases.

Exhibit: Bermuda Composite Q1:20 Combined Ratio Contributions

Source: Company Reports, Inside P&C

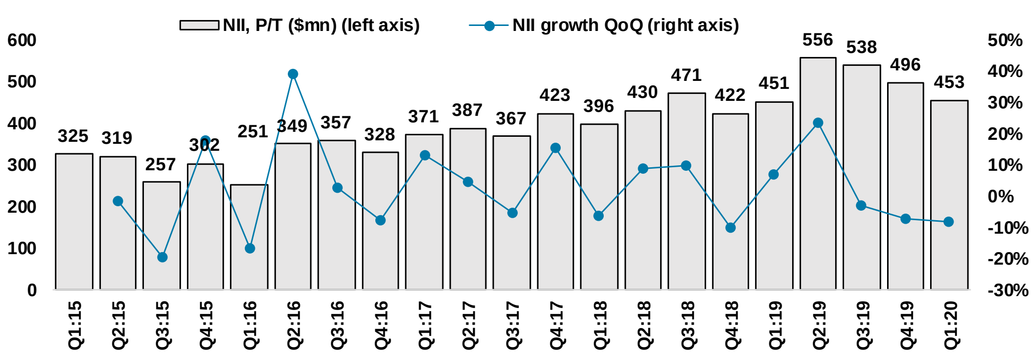


**Arch results exclude mortgage*

Q1:20 NET INVESTMENT INCOME DOWN ~10% Q/Q

Exhibit: Bermuda Composite NII Since 1Q15

Source: Company Reports, Inside P&C



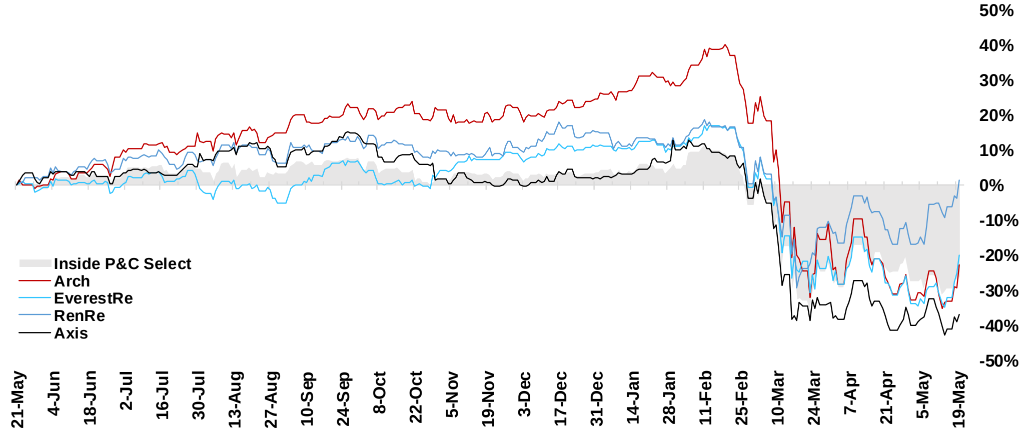
Net investment income across the composite fell by nearly 10% QoQ to $453M in Q1:20 from $496M in Q4:19, but was otherwise flat from the year before. The drop from the previous quarter came mostly from Arch, where NII was down to $113mn from $154mn in Q4:19.

Arch said the fall mostly related to declining yields in the quarter.

VALUATION REVIEW: BERMUDA STOCKS HIT HARD BY COVID-SELLOFF

Exhibit: 1-year stock performance for Bermuda composite

Source: SNL, Inside P&C



Bermuda stocks took a plunge in March as financial markets became gripped with fear over the longer-term economic repercussions of the pandemic. Bermuda stocks were hit harder than the P&C sector more broadly, as investors looked for ways to limit volatility and sought out names with more stable streams of earnings.

As the market digested commentary from management on earnings calls, companies within the Bermuda sector deemed to be less exposed to Covid-19 losses saw greater improvement. Investors reacted strongly to the smaller than expected Covid-19 reserve charge and bullish outlook at RenRe.

The share price at Axis withstood a ratings downgrade from AM Best on the morning of the company's earnings call, as well as a withering critique from Axis co-founder John Charman, before turning lower among a broader market selloff.

This research report was written by Insider Publishing's Research team which includes Gavin Davis, James Thaler, Gianluca Casapietra, and Dan Lukpanov.