Twelve Capital Perspectives 2017 Outlook

Executive Summary

Twelve Capital continues to see a number of attractive investment opportunities in the insurance sector for the first half of 2017:

- Spread differentials between insurance subordinated and bank subordinated bonds remained throughout 2016 and continue to persist into 2017.

- Twelve Capital has a strong pipeline of attractive Insurance Private Debt transactions offering investors an interesting illiquidity premium in this area of the market.

- The attractiveness of Insurance-Linked Securities (ILS) as a diversifying asset class is being reinforced by new perils for these securities and by new issuers entering the market.

- Insurance Equities are supported by high dividend yields, whilst conditions remain supportive for further consolidation in the industry. Increasing exposure to insurers that are potential takeover targets could potentially enable investors to capture premiums in the range of 25-40% in our view.

- Twelve Capital's Best Ideas strategies have gained further appeal as these portfolios offer similar returns to pure Insurance Bond or Cat Bond portfolios whilst typically having lower levels of risk and volatility.

Fundamental Overview

In Twelve Capital's view, the ability of the insurance sector to successfully navigate multiple bouts of market stress witnessed throughout 2016 is proof positive of the resilience Twelve has championed over the years and a further demonstration of the sector's high level of relative attractiveness from an investment perspective.

During 2016, insurers dealt with market volatility induced variously by: worries over China growth, oil price falls, the UK's vote to leave the European Union, material decline in interest rates, the US presidential election and a referendum on constitutional reform in Italy. Furthermore, Munich Re estimates that disaster events (both natural and man-made) generated USD 50bn of insured losses during 2016, 33% higher than 2015, though broadly in line with the 10 year average of USD 53bn.

Despite the above, solvency ratios for the insurance sector remained strong (Solvency II ratios typically stand above the 150% mark), no bond coupons were missed (nor were there any institutional bond redemptions missed in Europe) and equity investors saw sustained, if not increased, levels of dividend payments.

As a result, Twelve remains of the belief that insurance sector fundamentals are generally robust and that this is likely to support performance throughout 2017. In particular, insurer balance sheets are seen as strong, having benefited, for example, from substantial post global financial crisis and pre-Solvency II strengthening. Notable prior action taken by insurers has included: conservative policyholder and shareholder distributions, financial debt deleveraging, disposals of non-core operations and an ongoing cautious approach to investment management. Insurance company assets remain mainly invested in diverse, investment grade dominated, fixed income portfolios (approximately 80% of invested assets, compared to equities at only c. 5%).

The coming year has the potential to deliver further political and macroeconomic driven market volatility, given the upcoming elections in France, Germany and the Netherlands. With this in mind, insurance management teams are not expected to seek to lower balance sheet strength any time soon, and this is to the benefit of both credit and equity investors. If the low yield environment continues, we believe there remains material scope for additional management action to mitigate macro headwinds, including further operational efficiency gains and technical margin improvements, plus a targeting of selective growth opportunities.

Looking ahead into 2017, the key fundamental drivers being considered in relation to portfolio positioning are as follows:

- Whilst interest rates have rebounded from their summer 2016 lows, rates still remain depressed by historical standards and there is divergence globally in this respect as well. At the time of writing, interest rates in Europe, the UK and Japan still remain below levels seen at the start of 2016. In contrast, rates in the US are higher. Where rates continue to be stubbornly low, Twelve Capital believes an ongoing challenge remains for the sector, particularly to life insurers who have provided long term investment return guarantees to policyholders. As a result, we expect a material gap to persist in 2017 between the yield generated by existing insurer investment assets and the new money reinvestment rate achievable for most life insurance companies. It is imperative therefore that insurers can demonstrate an ability to withstand low interest rates for even longer if necessary. Indeed, it is expected that low interest rate resilience will remain a key area of investor debate for the sector during 2017, this being examined in detail within the recent EIOPA European insurer stress test.

- The ‘quality’, not just ‘quantity’, of Solvency II ratios is likely to be another key theme during 2017. Twelve Capital believes there is a wide divergence around how the Solvency II regime is being applied in different EU member states, with implications for the robustness of insurer Solvency II positions. This is reflected, for example, in higher reliance on transitional arrangements to bolster ratios at some insurers but not others. Quality of ratios also shows itself in the degree to which stated solvency positions rely upon the benefit provided by smoothing mechanisms embedded within the regime, such as the ‘Ultimate Forward Rate’ (UFR), especially given the current interest rate environment. New price sensitive market disclosure is expected during 2017 (insurer ‘Solvency and Financial Condition’ reports) that will provide additional quantitative and qualitative information that can be used to compare and contrast insurers.

- The potential for non-life (re)insurers to lose their perceived defensive valuation premium is another important focus area for 2017. In recent years, we believe the wider market has placed such a defensive premium on non-life (re)insurers, given factors such as their lower embedded market risk and absence of product investment guarantee risks. During 2017, pricing of insurance risk in most non-life (re)insurance markets are expected to remain very competitive, in part due to the continuing oversupply of capital. This general view is supported by the results of the recent January 2017 reinsurance renewals season. Furthermore, Twelve will be closely monitoring the adequacy of technical reserve strength throughout the year as well. During 2016, a strengthening of reserves was noted, and although in most cases these were relatively modest, we are closely monitoring whether or not such changes were just the prelude to more substantial adjustments going forward.

- Over the next twelve months, conditions are likely to remain conducive towards ongoing insurance sector consolidation in our view. M&A is a key element of Twelve Capital’s insurance equity proposition and is discussed in more detail later in this report.

Insurance Bonds

In relation to fixed income investments, European insurers are expected to continue redeeming institutionally placed bonds at their first call date throughout 2017, thereby maintaining their very strong track-record in this regard. This is in contrast to US insurers who have now largely moved to a stance of economic calls only. We see three main drivers for European insurers calling institutionally placed bonds, as outlined below:

Regulatory change continues to be a key driver: a large number of legacy Solvency I bonds* remain outstanding that need to be replaced by instruments fully compatible with Solvency II rules.

The low yield environment: insurers are able to refinance bonds coming to call cheaply, providing an economic incentive to redeem.

Reputation matters: institutional investors still expect bonds to be called and thus a virtuous economic circle is in place. Ongoing redemptions aid effective market access and insurer financial flexibility.

*These bonds have been structured to meet Solvency I rules that now have been replaced by Solvency II.

On fixed income supply, we do not see a material refinancing pipeline in the year ahead. Nonetheless, there may be additional opportunities created in the primary market, generated by M&A related issuance for example, or by the continued emergence of debut issuers being insurance groups that have not issued bonds into bond markets before.

The insurance sector remains one of the most compelling from a spread perspective within the European iBoxx IG index, a situation that has persisted throughout 2016 and one which is anticipated to continue during 2017. Indeed, the average spread differential between insurance subordinated and bank subordinated bonds, for instance, is 176bps (as illustrated in Figure 1). For European Insurance Bonds, we typically see the yield to expected buy back in excess of 3.5%[1] on average depending on rating and the structure of risk of individual securities.

Almost exactly a year since successfully transitioning into the new Solvency II regulatory regime, the sector has continued to demonstrate highly robust capital ratios. This supports our long term view that insurance companies are well capitalised with healthy balance sheets and strong underlying fundamentals.

There was approximately EUR 22bn of new issuance in 2016, from both 'new' and 'old' issuers alike. Primary issuance in 2017 has started strongly. At the time of writing, there have already been five new issues coming to market. Nonetheless, refinancing linked to upcoming bond calls and maturities do not point to a similar level of supply in 2017 as per 2016. Furthermore, spreads on these new issues have remained compelling, one such example being the Dutch insurer NN's recent issuance of a dual tranche senior and subordinated deal with an all in yield to expected buy back of 4.77%.

Although the above new issuance was unrelated to NN's recent agreement to purchase Delta Lloyd for approximately EUR 2.5bn, this is one of a number of M&A transactions that has taken place across the sector during 2016. In our view, that M&A theme is likely to continue over the next twelve months. This topic is further highlighted later in this report.

Why does subordinated insurance debt continues to offer a significant yield differential to other sectors, as seen in the figure below? We believe that one of the reasons behind this is the fact that insurance represents only a small fraction of the overall European index, at approximately 3.5% (whereas Banks, for instance, makes up a much larger 7% of the index). As a direct consequence of this, the sector is relatively under researched and tends to be overlooked by the wider investment community in our view.

Furthermore, spreads across the vast majority of sectors have been compressed during 2016, as a direct result of Central Bank bond buying programmes. Indeed, this includes senior insurance bonds, which have been a beneficiary of such activity and seen spread compression as a result. As the persistent need for yield continues to drive investors, we believe that their attention is likely to be turned to subordinated insurance bonds as the year progresses.

In summary, for Insurance Bonds, we believe both technicals and fundamentals remain highly supportive for 2017. The insatiable 'hunt for yield' is a key driver here, despite the recent moderate reversal in government yields during 4Q16. It is also highly probable that Central Banks will keep rates lower for longer (particularly in Europe), as a number of political risks come to the fore throughout the year.

Figure 1: Average sector spreads

Spread (December 2016)	
iBoxx EUR IG	89.0
Insurance Subordinated	347.5
Bank Subordinated	172.5
Metals & Mining	126.1
Autos	99.0
Media	96.1
Telecoms	94.7
Chemicals	85.0
Utilities	90.1
Services	77.9
General Industrials	66.0
Bank Senior	55.7
Insurance Senior	60.1
Retail	50.8
Transport	56.6
Healthcare	47.6
Building Materials	46.0
Technology	34.0
Capital Goods	31.0

Source: J.P. Morgan, Markit, Bloomberg.

[1] Figures in EUR, adjusted related to FX.

Private Debt

During the course of 2016, Twelve's Insurance Private Debt strategy successfully completed eight transactions, totalling EUR 160m in size. Further details are displayed in Figure 2 below. Despite the inception of Solvency II at the beginning of last year, the majority of these transactions were closed with issuers domiciled outside the Solvency II jurisdiction. Furthermore, allocations were increased to issuers domiciled in the US and, for most portfolios, this region is now the largest in terms of country allocation.

All transactions entered into during 2016, with one exception, have a floating coupon in order to help reduce portfolio duration. The average yield to maturity of these investments is around 8.5% and most transactions are in USD. The motivation for insurance companies to seek such capital was mainly to raise additional solvency financing, as well as being for business expansion. In one case, the debt instrument was used to reduce a quota share reinsurance contract and this, in our view, is a clear sign that Private Debt not only serves as a complement to reinsurance but, on occasion, can be seen as a partial substitute for reinsurance.

The appealing mix of elevated spread levels, low duration and the benign default history of insurance undertakings, attracted additional assets to this strategy throughout the year. Whilst we were able to grow existing investment vehicles during the last twelve months, new offerings were also set up which allocated to this strategy.

The well-managed and disciplined growth of Twelve's Insurance Private Debt strategy has so-far allowed for a steady increase in the average size of individual transactions within our portfolios over time, and we expect this to continue going forward. In the more immediate term, Twelve sees a large number of potential Insurance Private Debt investment opportunities for 2017 and looks forward to an ongoing dialogue with issuers and investors alike over the coming months.

Figure 2: Transactions arranged by Twelve Capital in 2016

Source	Type of Insurer/ Domicile	Coupon	YTM (%)	Currency	Investment Amount (in m EUR)	Maturity	Purpose
Primary	Run-off specialist/ Bermuda	3m Libor + 7.75%	8.75	USD	19	2023	Solvency financing
Secondary	Bulk annuity writer/ UK	9.75%	8.22	GBP	26	2025	Solvency financing
Primary	Composite/ Slovenia	3m Euribor + 7.8%	7.8	EUR	30	2026	Solvency financing
Primary	US Household/ USA	3m Libor + 5.75%	6.75	USD	29	2026	Business expansion
Primary	US Household/ USA	3m Libor + 8%	9	USD	29	2022	Reduction of quota share reinsurance
Primary	US Household/ USA	3m Libor + 8%	9	USD	14	2026	Business expansion
Primary	Employers liability/ USA	3m Libor + 8.5%	9.6	USD	5	2026	Maintenance/ upgrade of rating
Primary	US Household/ USA	3m Libor + 8%	9	USD	8	2026	Establishment of insurance balance sheet
		Average	**8.5**	**Total**	**160**		

Insurance-Linked Securities

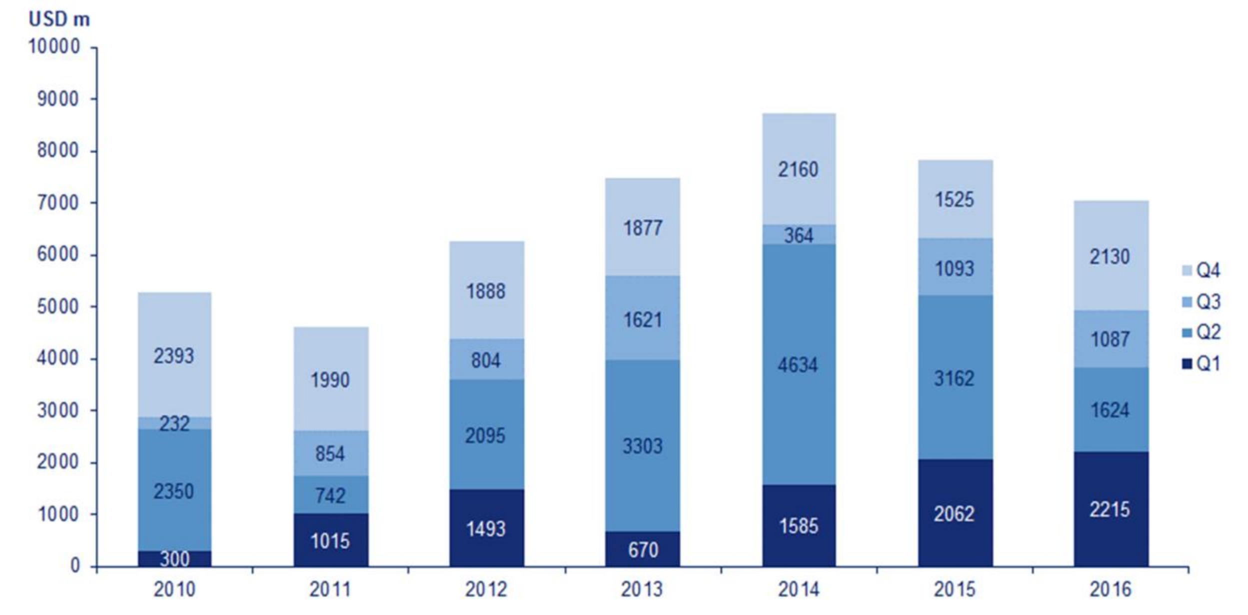
Catastrophe Bonds

The Cat Bond market saw a shift in supply-demand dynamics during 2016. The first half of the year showed strong demand being followed by a slowdown in supply during the third quarter. As a consequence, more so than in previous years, the third quarter of 2016 was a strong sellers' market and this resulted in lower than usual levels of spread widening over the period.

As issuance picked up again in the fourth quarter totalling USD 2.13bn, the outstanding issue volume for the Cat Bond market at year end hit USD 26.06bn, a record high as illustrated in Figure 3. The issued bonds were generally more junior in nature and paid higher coupons as a result, however overall risk-adjusted yields were slightly reduced. New sponsors and additional exposure types are demonstrating that the Cat Bond market continues to innovate. For example, one bond issued during 2016 covered operational risks whilst another bond brought to market during the year covered temperature related weather risks.

Twelve expects an active first half of the year in terms of Cat Bond new issuance. As has been observed in 2016, new perils, such as Typhoons in the Philippines, and market participants should continue to grow the asset class throughout the coming six months. Although new issuances last year resulted in a slight reduction in risk-adjusted yields, a continuation of this trend is unlikely in our view, particularly because a market heavyweight, Everglades 2014, will mature during the year. A re-issuance of this relatively senior instrument should curtail such a trend. Approximately USD 6.6bn of Cat Bonds will expire in 2017. We expect a large part to be renewed over the period.

Figure 3: Cat Bond new issuance over time



Source: Twelve Capital, Aon Benfield Securities, Inc., Artemis (4Q 2016 Catastrophe Bond & ILS Market Report).

Private ILS

In terms of the Private ILS market, the important January 2017 renewals period has concluded and we believe our portfolios have a diverse book of investments. This year the focus was very much on renewing existing transactions, only adding new capacity in exceptional cases, and ensuring that renewal prices for existing capacity were appropriate given the underlying level of risk.

As a result, three new investments were added to the portfolios this year, alongside the renewal of more than twenty transactions. Twelve’s portfolios broadly experienced a reduction in risk adjusted yields since natural peril models have seen an update which led to higher levels of risk attribution for the same exposures when compared to last year.

Although 2016 saw sizeable insured losses to the insurance industry amounting to approximately USD 50bn according to Munich Re, overall costs totalled USD 175bn when taking uninsured losses into account. Such a figure is close to that experienced during 2012, where losses totalled approximately USD 180bn. As a result, investors have been reminded that losses due to natural perils can be substantial and that appropriate risk analysis and premium calculations are prerequisites before any investment should be made in the space. Furthermore, the so-called protection gap that quantifies losses shouldered by economies without insurance remains substantial, and this leaves ample room for additional participants to enter the market with new and innovative transactions.

Insurance Equity

Global Insurance Equities (in USD) ended the year +3.87%, although underperformed the wider market by 145bps (MSCI World Insurance Equity Index[2] vs MSCI World Equity Index[3]). Looking back to the mid-year point, a positive performance for the year seemed unlikely, with a volatile first six months of the year being dominated by China growth rate concerns, commodity price declines and the outcome of the UK's referendum on its membership of the European Union. An indomitable second half performance was buoyed by increasing investor confidence, improving bond yields from recent lows and a pick-up in insurance M&A. From a geographic stand-point, US insurance equities were by far the strongest performers, with the post Trump election rally only extending these gains. By contrast, the Asia-Pacific region was a laggard. Earnings growth remained sluggish for much of the sector throughout the year, so performance has largely been driven by a reduction in cost of equity.

> Twelve's expectations for key themes likely to impact the sector during 2017 are little changed year-on-year. These include:
>
> **1. Interest rates** remaining at historic relative lows likely continuing to be a headwind for most regions, although some material geographic dispersion regarding the rate of change is probable in our view. This position is slightly nuanced from the 'even lower for even longer' scenario discussed in Twelve's 1H16 Perspectives.
>
> **2. Reserving concerns** continuing to swell.
>
> **3. M&A** proliferation continuing.

There remains a strong correlation between interest rate expectations and the sector's stock performance in our view, particularly in the life insurance sub-sector. Despite the recent uplift in many government bond yields, there is not much change from the starting point of 2016 in the sense that we remain at low levels on a historic basis. With market expectations now looking for a divergence between major economies, this could lead to some significant regional stock dispersion.

Broadly speaking, positive sentiment towards US interest rate rises has been a significant benefit for US life insurers. While any earnings uplift takes a number of years to come through, there has been a more immediate reduction in the risk premia associated with these names, given the improved long-term economics of their products. Having said this, we caution that some positivity may in fact already be factored into share prices. In Europe, and indeed the UK, insurers seem destined for another year with low rates continuing to act as a headwind to earnings. Across Europe, names with 'self-help' stories and attractive dividend yielding stocks should be viewed as a positive in this environment, with some valuation multiple expansion still plausible.

The insurance sector carries one of the highest yields in Europe, coming in at 4.9% compared to the market at 3.4% (see Figure 4). As bond yields remain low, certain stocks will continue to be viewed as bond proxies. While earnings growth remains low for the sector, we highlight the resilience of these earnings, with consensus expectations largely being met, while many other sectors have dramatically fallen short.

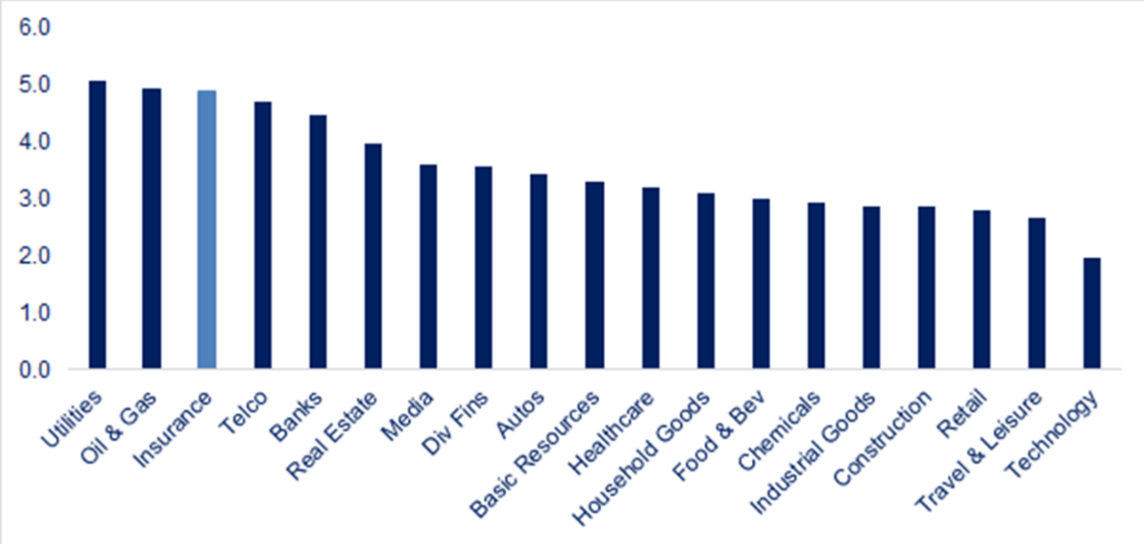
The emergence of some, thus far, relatively minor reserving concerns for the sector gathered a little more pace in 2016, particularly in the US. While some appear to have been company specific issues, there are a number of lines of business that look to be under increasing pressure on an industry basis. Reserve releases have heavily supported reported earnings across many companies in recent years. Any material slowdown or an emergence of shortfalls will likely lead to a spike in cost of equity assumptions and therefore a sharp share price fall. An investment strategy focused on the most robust balance sheets should help to alleviate this risk.

We had previously highlighted that the last eighteen months had seen a plethora of M&A in the insurance sector and that this was expected to continue. While 2016 did see a slowdown in such activity, we attribute this to macro volatility, as opposed to a change in the underlying factors driving the consolidation trend within the insurance industry. Indeed, as the macro environment somewhat stabilised in the final quarter of 2016, there was a dramatic uptick in M&A activity.

[2] The MSCI World Insurance Equity Index is an Index focused at measuring the equity performance of the c.80 largest listed global insurance companies weighted by free-float of market capitalisation.

[3] The MSCI World Equity Index is a broad global equity benchmark that represents large and mid-cap equity performance across 23 developed markets countries. It covers approximately 85% of the free float-adjusted market capitalisation in each country and does not offer exposure to emerging markets.

Figure 4: Euro Stoxx 600 Dividend yield by sector (%)



Source: Bloomberg as at 31 December 2016.

Twelve continues to be of the view that strong investment returns can be attained from effective management of an equity strategy based on M&A. This strategy materially outperformed the Global Insurance Index in 2016 and current conditions remain supportive for further consolidation, namely: i). Subdued organic growth opportunities; ii). Increasing importance of scale; and, iii). Cheap financing. Over the last twelve months, typical M&A premiums for the sector have been in the 25-40% range.

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About Twelve Capital

Twelve Capital is an independent investment manager specialising in insurance investments for institutional clients. Its investment expertise covers the entire balance sheet, including Insurance Bonds, Insurance Private Debt, Catastrophe Bonds, Private Insurance-Linked Securities and Insurance Equities. Twelve Capital also composes portfolios of its Best Ideas. The firm's capital solutions are drawing the world of insurance and reinsurance into a closer, more productive relationship with capital markets. Twelve Capital was founded in October 2010 and is majority-owned by its employees. It has offices in Zurich and London.