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Worth a premium

Global commerce appears to be taking the summer off. The 23.4% plunge in Taiwan exports for June, measured year over year, is the steepest monthly drop since 2009 in the record books of the People's Republic of China. In May, the world's third-largest shipping line, CMA CGM S.A., warned of weak volumes and weaker prices, citing a "destocking phenomenon that is continuing in many parts of the world." And the People's Republic, stuck in the debt it's so diligently racked up, has reported a 5.4% tumble (calculated at an annual rate) in June producer prices.

It may not be the most auspicious backdrop for an upbeat story on a trade credit insurer, but *Grant's* is bullish on Coface S.A. (COFA on the Paris Stock Exchange). A provider of coverage to around 100,000 customers in nearly 200 countries, Coface is well-capitalized, pays an inflation-beating dividend and is inexpensive even at higher loss rates. Time will tell if it's priced for the recession that hasn't happened yet.

Founded in 1946 by the French government to facilitate foreign trade, Coface was privatized 48 years later, in 1994. In 2002, Natixis S.A., the French investment bank, acquired a controlling stake, ultimately buying the company whole in 2006, only to hand it off to public investors in a 2014 IPO.

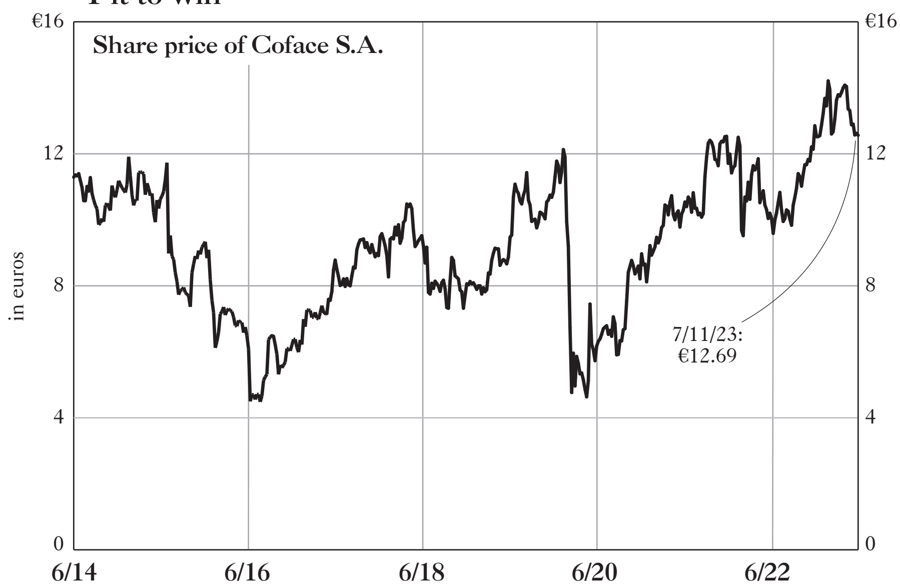
The investors contracted buyer's remorse as the then-CEO, Jean-Marc Pillu, tried to turbocharge the top line through aggressive expansion in Latin America and the Asia-Pacific region. Losses followed: EPS declined by 67.5% from 2015 to 2016, and shares traded as low as 38% of book. Not until the lockdown months of 2020 would they fetch a steeper discount.

Out went Pillu in 2016, and in came Xavier Durand, an operationally focused, 20-year veteran of GE Capital. The dash for growth was out; prudent underwriting and cost savings were in. "Fit to Win" was the plan as the underwriting process, incentive structures, and emerging-market data-collection techniques came in for overhaul. Within a year, loss ratios (i.e., claims paid divided by premiums earned) in Latin America fell to 60% from 113%, those in Asia to 129% from 147%. Accounting for dividends, Coface has generated a 16.2% compounded annual return in dollar terms since Durand's appointment.

Coface is the smallest of three major players in what amounts to a trade credit insurance oligopoly. As of 2021, the largest, Allianz S.E., acquirer of the former Euler-Hermes Group, commanded a 26% market share, while the No. 2, Atradius, now part of Grupo Catalana Occidente S.A., held a 20% share and Coface accounted for 15%. The trio, which control 61% of the trade credit market, cede the remaining 39% to national or regional organizations, including the largest, China Export and Credit Insurance Corp.

Coface is broadly engaged in trade credit risk. It insures accounts receivable (89.8% of 2022 gross revenues); factors receivables (3.9%); and underwrites surety bonds for market, environmental, customs and tax risks (3.2%). It

'Fit to win'



source: The Bloomberg

also sells data and insights about trade and debt collections (3.1%).

The moat to credit insurance is people and infrastructure. You need teams worldwide to gauge the risk that a client bears when it extends credit to its counterparties. Coface, geographically diversified, generates 27.2% of trailing revenues in the Mediterranean and Africa, 20.6% in Northern Europe, 20.4% in Western Europe, 9.7% in Central Europe, 9.4% in North America, 7% in Asia Pacific and 5.6% in Latin America. It employs 4,721 people, more than 600 of whom are underwriters and credit analysts, in 58 countries. Needless to say, this is not easily replicable.

Coface's exposures are diversified among industries, too. According to the 2022 annual report, agriculture, meat, agri-food and wine accounted for 16.6% of insurance exposure; minerals, chemicals, oils, plastics, pharma and glass, 14.9%; construction, 10.9%; and with the remaining exposures spread across an additional dozen broad industry sectors.

Insurance is a cyclical industry, but, on the one hand, the underwriting cycle for property and casualty underwriters is decoupled from the overall economy. Credit insurance, on the other, is directly tied to GDP: Claims costs are negligible during booms, outsize, potentially ruinous, in recessions.

Alert to the procyclical nature of its business, Coface takes little risk in its investments. As of March 31, it consigned 75% of its €3 billion investment portfolio to bonds; 16% to loans, deposits and other financial instruments; 7% to real estate and 3% to equities. The vast majority of the bond portfolio sits in government paper and has an average duration of 3.2 years. Still infected with the ground-hugging interest rates of the not-so-distant past, the portfolio yields a meagre 0.5%, far below Coface's long-run average of around 3%. Critically, new money invested in the portfolio yields just over 2%.

Earning little from the investment of its float, the prudent credit insurer takes all the more care in how it underwrites risks. One can conjecture as much by comparing combined ratios among companies and between industries.

Thus, in 2022, the average combined ratio, which divides the sum of claims-related losses and expenses by premiums earned, was 102.7% for property and casualty insurers but a mere 64.9% for Coface, besting rival Atradius's 72.5%.

Coface at a glance

all figures in € mns except per share data

	TTM*	2022	2021	2020	2019
net premium earned	€1,140.3	€1,115.6	€800.5	€645.1	€882.0
net income	284.8	289.9	226.1	86.5	147.6
earnings per share	1.91	1.95	1.52	0.57	0.92
book value per share	13.52	13.52	14.37	13.29	12.06
shares outstanding	150.2	150.2	150.2	152.0	151.0
loss ratio	40.6	36.0	33.3	47.7	45.0
cost ratio	25.7	28.8	31.3	32.1	32.7
combined ratio	66.3	64.8	64.6	79.8	77.7
net debt	40.0	55.0	110.0	77.0	162.0
total assets	7,586.3	7,586.3	8,039.0	7,552.8	7,382.9

*For the 12 months ended March 31, 2023.

sources: company reports, the Bloomberg

By all accounts, 2022 was an exceptionally good year, and a 64.9% combined ratio is unsustainable. In the Great Recession, the loss ratios of all three major credit insurers soared, though briefly, above 80%. Euler-Hermes, for example, saw its loss ratio shoot to 82.1% in 2009 from 48.1% in 2007 before settling back at 42.1% in 2010. Coface, a subsidiary of Natixis at the time, suffered a peak loss ratio of 97.7% in 2008, up from 49.1% in 2007, before recovering to 53.1% in 2010. Even so, credit insurance can—and Coface's business did—grow in an economic downturn. Despite some splotches of red ink between 2007 and 2010, Coface compounded gross premiums earned by 4.7% in euro terms.

Insurers measure their capitalization by the so-called solvency ratio, which divides total equity by the solvency capital requirement, a regulatory calculation that includes weightings for operational, counterparty, market and underwriting risks. Management targets a ratio of between 155% and 175%; it was 201% as of year-end 2022. Higher is better.

Coface would remain well-capitalized even in a serious economic downturn, at least according to its own calculations. In the event of a "one-in-20-year" crisis, management estimates that the solvency ratio would fall to 188%. In a "one-in-50-year" crisis, something comparable to the Great Recession, 180% is the expected result, still above the in-house upper target of 175%.

Notably, these simulations do not account for management's dexterity and resourcefulness during the trial by fire. Investors ran for cover following Russia's invasion of Ukraine, knocking 33% off of Coface's market value between Feb. 23 and March 7. At the start of hostilities, exposure to the embattled region totaled €4.8 billion; by June 30, it had fallen to €1.4 billion. Since trade receivables typically run for between 60 and 180 days, Coface can turn over its insurance book in a matter of quarters.

As part of in-house risk-management policy, individual loss exposures are capped at 2% of net asset value, and reinsurance protection kicks in above an annual group net loss ratio of 110%. Net debt is negligible at €40 million, and operating income covered interest expense by 11.4 times in the first quarter. The company is rated Baa1, at the lower end of investment-grade.

Coface's insurance subsidiary is rated several notches higher. Moody's Investors Service gauges the insurance operations at A2, or solid investment-grade, and raised its outlook to positive in an Oct. 11, 2022 update. Insurance-focused A.M. Best. Co., Inc. rates the unit single-A.

"During the invasion of parts of Ukraine by the Russian army," Thomas Jacquet, head of Coface investor relations, tells analyst Luke Burke, "we did better than our competitors when it came to loss ratios and risk management." Jacquet credits "a mixture of operating efficiency, quality of data, and underwriting discipline. I think it's probably fair to assume that our risk appetite is probably slightly lower than our peers."

Anticipating Jacquet, Hadley Cohen, who rates Coface a buy for Deutsche Bank A.G., had this to say last autumn: "[W]hereas Coface was likely the weakest-positioned of the global trade credit insurers ahead of the previous crises, we would now consider it to be one of the strongest (if not the strongest)—largely thanks to both significant improvements in its Debtor Risk Assessment processes and an incredibly strong capital position."

"There's a lot of risk out there," Durand acknowledged on the May 25 earnings call, including geopolitical tensions, the war in Ukraine, inflation, rising interest rates and their knock-on effects as well as energy security and the lack of it. "We were also seeing some manifestations of that through the number of insolvencies, which continues to rise and, in many economies, is now at or higher than the 2019 level."

What does this mean for the company? Durand went on to explain: "We are staying absolutely true to our values and we're continuing to do what we said we would do. No. 1, this means being thoughtful about where we invest our money and what kind of business we write. No. 2 means making sure we focus on clients and deliver superior service.... We're being disciplined about cost, and we are managing the risk portfolio consistently with the long-term trends that we're seeing. We're also managing the new risks when they show up."

Four of the five analysts covering Coface rate the shares a buy, with the single dissenter saying hold. Over the past 12 months, insiders have sold a net 61,479 shares for proceeds of €887,750; CEO Xavier Durand owns 264,500 shares, worth €3.4 million.

The stock changes hands at 6.8 times trailing earnings to deliver a 12% dividend yield, figures that cyclically low underwriting losses certainly flatter. At an 80% combined ratio—management's long-term target and the average for the industry over the course of an economic cycle—earnings per share would fall to around €0.94 from €1.86, leaving Coface valued at a 13.5 multiple and, assuming an 80% earnings payout ratio (the company's payout target), with a 6% dividend yield.

At 91% of book value, Coface trades below the valuation at which prior credit insurance M&A transactions took place. Thus, Grupo Catalana Occidente completed its acquisition of Atradius in 2012 at a value of 115% of book value. In 2018, Allianz acquired the remainder of Euler-Hermes at a valuation of two times book.

Other publicly traded insurers think enough of Coface to hold its stock. Allianz, for instance, which bought Euler-Hermes, owns 5.1% of shares outstanding in Coface. In 2021, Natixis sold its stake in Coface to Arch Capital Group Ltd., which now owns 29.9% of shares outstanding, just below the 30% limit allowed under French takeover law. Should Arch Capital Group wish to join Grupo Catalana Occidente and Allianz in owning a trade credit insurer, Coface's valuation would not stand in the way, at least not at current prices.

"Arch Capital, who I think of as being a very smart group, has taken themselves up to just below the mandatory takeover threshold under French law," Paul J. Isaac, friend, founder of Arbiter Partners Capital Management, LLC and himself a holder of Coface, tells *Grant's*. "So, you've got two insurers, who are both trading at something better than twice their tangible books, who seem to think that this is a perfectly reasonable thing for them to own at around tangible book, or a little less."

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