RMI Holdings & Hastings plc

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During mid-December 2016, while most fund managers and analysts were gearing up for their year-end holidays, RMI made perhaps its most significant announcement since its start of life as a separately listed holding company in 2011. The announcement being a debt-funded acquisition of an associate stake in fast-growing, agile, digital UK direct lines short-term insurer, Hastings Group Plc (HSTG), went largely unnoticed by the analyst community.

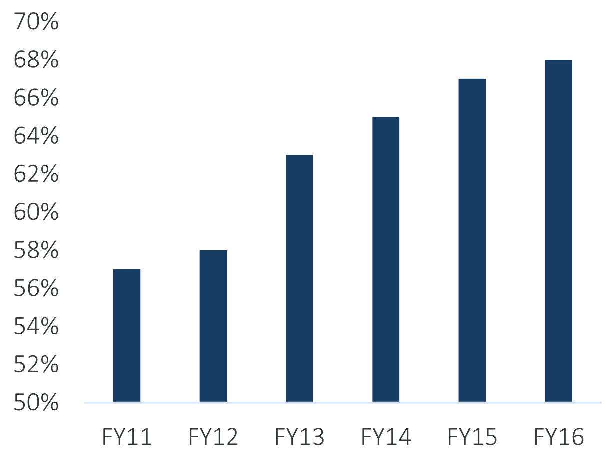
We have often written about the optionality embedded in a business such as RMI. We admire and look for businesses that want to diversify, but with a strict focus on the need to find areas for capital deployment that will enhance the return-on-capital profile of the Group and not detract from it. Strict discipline around capital management has become a rare commodity among the domestic management teams and we find the 29.9% acquisition of Hastings to be a good example of this. Hastings generates a return on capital employed of close to 50% (as of the latest reported numbers) and we feel this high-return profile should be sustained as the business continues to take market share in the UK motor-insurance space and scale benefits contribute to increased profitability.

Importantly, we believe RMI did not overpay for the associate stake with the acquisition price of GBP2.40/share, representing a forward 11.4x earnings, or put another way, a 25% discount to what we would have considered fair value for a business with similar characteristics.

The UK motor-insurance market is one we have tracked closely for several years, as one the core holdings in our offshore High Street Equity Portfolio has been Admiral Plc, another direct lines UK short-term insurer. Over the past few years, the UK market has been open for disruption by online insurance aggregators, also known as price comparison websites (PCWs). The UK has been one of the most rapid adopters of this technology with over two-thirds of all motor insurance now written through PCWs. The real losers in this space are the larger incumbents whose legacy systems and large broker networks have not reacted quickly enough to the changing consumer behaviour. In a very short space of time, the need for taking car insurance from a broker disappeared as consumers could shop around for an insurance quote in a matter of minutes from the comfort of their living room sofa.

The rise of PCWs has also led to a rise in the number of insurers who solely focus on algorithms that could accurately price risk within split seconds, or within the time it takes the potential client to click “submit”. The real value proposition for the client comes down to lower insurance premiums as a very costly intermediary is removed from the selling process, with the value shared between both the insurer and the client.

PCW penetration (UK)



Source: Hastings; Anchor

Focussing more specifically on the Hastings business model, we find the unique manner in which the underwriter operates in a separate profit centre to the retail business particularly appealing. There is an inherent conflict between the underwriter and the retail business. The underwriter is incentivised to maintain a targeted loss ratio (Hastings has a targeted loss ratio of 75%-79%), which results in strict pricing discipline, while the retail business is incentivised on volume and the additional value extracted from each new client.

A typical transaction would involve the retail business requesting a quote from a potential client on the PCW which is then forwarded to the underwriter, who quotes the retail business a premium value the underwriter believes will result in the targeted loss ratio being met.

Should the client accept the quote, the retail business has to pay the underwriter's quoted premium to the underwriter and may then charge the client a rate that is slightly lower (essentially taking a small loss on the premium), if the retail business believes they can extract more from the client in the form of value-added services, such as premium financing. This entire process happens within a matter of split seconds, therefore the accuracy of the insurance algorithm is what separates the insurers who make profits on underwriting from those that don't. Most general insurers in the UK don't make underwriting profits. Hastings does.

Another important dynamic at play is the understanding of pricing elasticity. For every 1% drop in the value of an insurance quote, volumes are likely to increase by 6%. Therefore the retail business' ability to predict the potential revenue from value-added services they will gain by discounting the insurance premium by a few percentage points, plays an important role in driving volume for the underwriter.

Make no mistake, this business relies very heavily on proprietary algorithms and data built up over time, giving the Group a healthy economic moat protecting the business from the threat of new entrants.

Management have made public their intention of reaching 3mn policies during 2019, an increase of 20% over a two-year period. By making public the targeted loss ratios, management are effectively stating that growth must not be at the expense of profitability (maintaining set margins). We think this will translate to an EPS CAGR of c. 20% for at least the next two years, while the cash build-up reduces the leverage ratios thus freeing more cash with which to make dividend payments.

By our estimates of future EPS growth, Hastings Plc is trading on a 12m rolling forward PE of 13.5x and a 12m rolling forward dividend yield of 4%.

Coming back to the attractiveness for both RMI and OUTsurance, it appears as there may be attractive synergies between OUTsurance's direct approach and the digital approach from Hastings, especially in Australia, a market that seems ready for the adoption of PCWs. OUTsurance already has an established direct-lines insurer in the form of YOUI. There is perhaps the opportunity for Hastings and YOUI to join forces and establish themselves as market leaders in the PCW space, should the Australian market present such an opportunity, although nothing has been formally communicated. For now, we are happy to be holders of both Hastings in our offshore portfolios and RMI in the domestic portfolios.

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