MOODY'S
INVESTORS SERVICE

ISSUER COMMENT
18 July 2019

Rate this Research

RATINGS

Rothesay Holdco UK Limited	
Rating Outlook	STA
LT Issuer Rating	Baa2

ROTHESAY LIFE PLC	
Rating Outlook	STA
Insurance Financial Strength	A3
LT Issuer Rating	Baa1

Source: Moody's Investors Service

KEY METRICS:

Rothesay Holdco UK Limited

£ million	2018	2017	2016
Total Assets	50,233	38,374	39,708
Total Shareholder Equity	2,571	1,753	1,485
Net Income attributable to the Group	85	261	262

Source: Company reports

Contacts

Dominic Simpson +44.20.7772.1647
VP-Sr Credit Officer
dominic.simpson@moodys.com

Antonello Aquino +44.20.7772.1582
Associate Managing Director
antonello.aquino@moodys.com

Evelyn Ocas Salazar +44.20.7772.1524
Associate Analyst
evelyn.ocassalazar@moodys.com

Rothesay Holdco UK Limited

Financial leverage increases following Tier 3 issuance; H1 19 profitability much improved

In July 2019, Rothesay Life Plc issued £300 million of Tier 3 subordinated notes thereby increasing the Group's financial leverage, albeit within our rating expectations and from a relatively low level at YE18. Rothesay Group has also reported markedly improved profitability in H1 19, in turn improving earnings coverage.

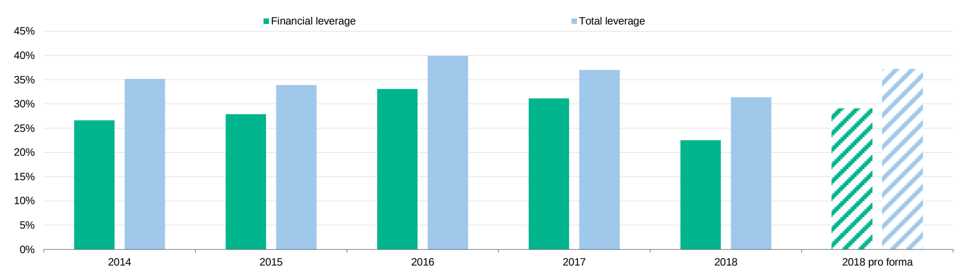
Rothesay's financial leverage reduced significantly in 2018

During 2018, our adjusted financial and total leverage metrics for Rothesay significantly reduced to 22.5% (YE17: 31.1%) and 31.4% (YE17: 37%) respectively (see Exhibit 1). This positive development benefited from increased equity and the repayment of a £500 million bank loan in relation to the Prudential transaction[1], and from the conversion of preference shares to ordinary shares.

Exhibit 1

Rothesay's financial leverage development

Adjusted Financial and Total leverage (%)



2018 pro forma based on Moody's calculation
Source: Moody's Investors Service, Company reports

Tier 3 issuance will increase leverage, but comfortably in the A range

However, the recent Tier 3 issuance, which we treat fully as debt, will meaningfully increase Rothesay's adjusted financial and total leverage, on a pro-forma YE18 basis, to around 29% and 37% respectively (see Exhibit 1). Nevertheless, leverage on this basis would be comfortably within our A rating range for financial flexibility. Furthermore, we would expect Rothesay to grow its shareholders' equity through retained earnings during 2019 which would curb the extent of the increase in leverage.

Rothesay states that the proceeds from the Tier 3 issuance will be used to fund its general commercial and corporate activities. In this regard, the Group wrote new business premiums of £0.7 billion in the first half of 2019 (£0.4 billion in the first half of 2018 excluding the

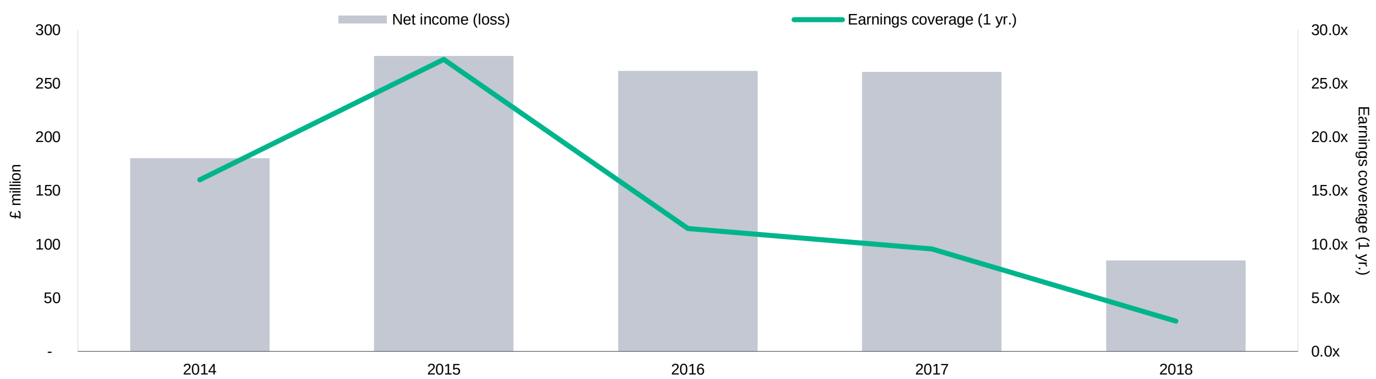
Prudential transaction), and describes its new business pipeline as very strong consistent with our view that there is strong demand for bulk annuities.

Initially, we estimate the debt issuance in itself will increase the Group's solvency II ratio by around 13% points to a relatively high level of c.190% on a pro-forma H1 19 basis, which is well above Rothesay's relatively moderate Solvency II ratio target range of 130-150%. However, we expect the ratio to reduce if the Group's new business pipeline materialises which would lead to a higher solvency capital requirement. The issuance will also somewhat dilute the quality of the Group's Solvency II capital.

Significant improvement in profitability at H1 19 will benefit earnings coverage

In 2018 Rothesay experienced a reduction in its earnings coverage to a relatively low level of 2.8x (YE17: 9.6x, see Exhibit 2), as a result of increased borrowing costs and reduced earnings. The Group's net income fell significantly to £85 million (YE17: £261 million) in 2018 driven by the de-risking and subsequent cautious reinvesting of the underlying assets from the Prudential transaction, as well as by widening credit spreads.

Exhibit 2
Rothesay's net income and earnings coverage development



Source: Moody's Investors Service, Company reports

However, for the first half of 2019, Rothesay reported unaudited pre-tax IFRS profit of £403m, a significant improvement on the pre-tax loss of £257 million at H1 18 (see Exhibit 3), given it has now successfully deployed all of the assets received from the Prudential transaction in a manner consistent with its original underwriting and long-term investment strategy.

Exhibit 3
Rothesay's pre-tax profit development

	2017	H1 2018	2018	H1 2019
IFRS profit before tax (£ million)	312	-257	102	403

Source: Company reports and trading statements

Rothesay's earnings coverage in turn will benefit from the improved earnings. However, coverage will be constrained somewhat by the additional combined £30 million of interest expense from the new Tier 3 issuance (coupon 3.375%) together with the £350 million of Tier 1 securities (coupon 6.875%) issued by Rothesay in September 2018.

Going forward, we continue to expect Rothesay's results to be somewhat volatile considering its focus on lumpy annuity business together with the fact that assets are often not sourced until after the execution of bulk annuity deals. This leads to an initial negative impact on profitability and places the onus on Rothesay and its peers to obtain the assets in order to meet the investment return assumptions factored into the transaction. However, aside from IFRS new business strain, Rothesay also focuses on embedded value metrics associated with new deals and in this regard the Prudential transaction drove the significant increase in the Group's new business value on a Market Consistent Embedded Valuation (MCEV) basis during 2018 to £453 million (YE17: £177 million).

Endnotes

1 In March 2018, Rothesay acquired a £12 billion portfolio of annuities from Prudential Plc

REPORT NUMBER 1185946

CLIENT SERVICES

Americas	1-212-553-1653
Asia Pacific	852-3551-3077
Japan	81-3-5408-4100
EMEA	44-20-7772-5454

MOODY'S INVESTORS SERVICE