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CREDIT OPINION
14 July 2020

Update

Rate this Research

RATINGS

Rothesay Holdco UK Limited

Domicile	United Kingdom
Long Term Rating	Baa2
Type	LT Issuer Rating - Dom Curr
Outlook	Stable

Please see the ratings section at the end of this report for more information. The ratings and outlook shown reflect information as of the publication date.

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Rothesay Holdco UK Limited

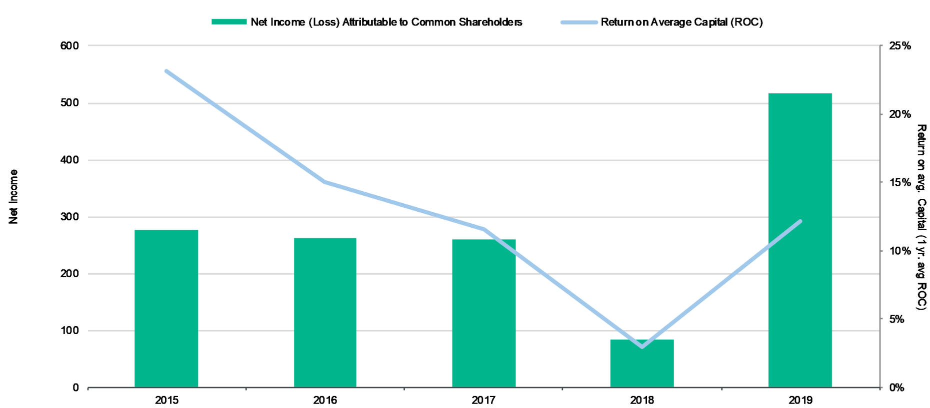
Update to credit analysis

Summary

The credit profile of Rothesay Life Plc (Rothesay Life), rated A3 (stable outlook) for insurance financial strength ("IFS"), is supported by Rothesay Group's (Rothesay, Group) good market position in the growing UK bulk annuity market and proven ability to acquire sizeable annuity portfolios, together with its good asset quality, profitability and financial flexibility. These strengths are mitigated somewhat by the Group's limited business and geographic diversification with a focus on lumpy UK annuity business, very high asset leverage and a relatively moderate Solvency II ratio target range of 130-150% although the Group's Solvency II ratio was 202% as at YE19.

As with other UK life insurers and notwithstanding business and solvency resilience shown to-date by the Group, we expect the coronavirus-induced economic downturn and financial market volatility to have a negative impact on Rothesay's earnings and capital, at least in 2020, although the extent of this impact remains highly uncertain.

Exhibit 1
Net Income and Return on Capital (1 yr. avg.)



Sources: Company reports and Moody's Investors Service

Credit strengths

» Established player in the growing and relatively concentrated bulk annuity market

» Proven ability to acquire sizeable annuity portfolios

» Good average return on capital performance

» Good asset quality with relatively conservative investment portfolio and no intangible assets

Credit challenges

» Limited business and geographic diversification with focus on UK annuities

» Significant exposure to longevity risk, although material use of reinsurance

» Very high asset leverage

» Relatively moderate Solvency II ratio target range of 130-150% although the Group's Solvency II ratio was 202% as at YE19

Rating outlook

The outlook is stable, reflecting our expectation that Rothesay will maintain good profitability, asset quality and financial flexibility as well as its good market position in the UK bulk annuity market.

Factors that could lead to an upgrade

Positive rating pressure could arise from: 1) Successful investment of assets received and profit generation in relation to bulk annuity transactions and/or; 2) Return on capital (Moody's definition) consistently above 6% and/or; 3) Reduction in adjusted financial leverage with earnings coverage consistently above 6x.

Factors that could lead to a downgrade

1) Return on capital (Moody's definition) consistently below 4% and/or; 2) Meaningful increase in adjusted financial leverage with earnings coverage consistently below 4x and/or; 3) Group Solvency II ratio consistently below 130%.

Key indicators

Exhibit 2
Rothesay Holdco UK Limited

Rothesay Holdco UK Limited [1][2]	2019	2018	2017	2016	2015
As Reported (Pound Sterling Millions)					
Total Assets	76,101	50,233	38,374	39,708	25,512
Total Shareholders' Equity	3,776	2,571	1,753	1,485	1,042
Net Income (Loss) Attributable to Common Shareholders	516	85	261	262	276
Total Revenue	17,656	12,451	1,435	8,975	3,087
Moody's Adjusted Ratios					
High Risk Assets % Shareholders' Equity	92.6%	85.5%	292.7%	452.9%	276.5%
Goodwill & Intangibles % Shareholders' Equity	0.0%	0.0%	0.0%	0.0%	0.0%
Shareholders' Equity % Total Assets	4.4%	4.6%	3.1%	2.0%	2.9%
Return on Average Capital (ROC)	12.2%	3.0%	11.6%	15.1%	23.1%
Sharpe Ratio of ROC (5 yr.)	179.7%	182.8%	379.1%	NA	NA
Adjusted Financial Leverage	29.1%	22.5%	31.1%	33.1%	27.9%
Total Leverage	34.6%	31.4%	37.0%	39.9%	33.9%
Earnings Coverage	8.4x	2.8x	9.6x	11.5x	27.3x

[1]Information based on IFRS financial statements as of the fiscal year ended 31 December. [2]Certain items may have been relabeled and/or reclassified for global consistency.
Sources: Moody's Investors Service and company filings

Profile

Rothesay, which essentially comprises a holding company (Rothesay Holdco UK Limited) and operating company (Rothesay Life), is currently the largest specialist annuity fund in the UK with assets under management (AUM) of around £54 billion as at YE19 (YE18: £36 billion). In 2019, Rothesay wrote over £16 billion of new bulk annuity business. Rothesay Life is a wholesale UK annuity writer with a focus on de-risking the liabilities of pension schemes and insurance companies via bulk annuity business and the acquisition of back-book annuities.

Rothesay was established in 2007 and initially owned by Goldman Sachs. Following the exit of Goldman Sachs in 2017, Rothesay has three main shareholders – Blackstone, GIC (both unrated) and Massachusetts Mutual Life Insurance Company (MassMutual, Aa3 IFSR, stable) which respectively have shareholdings of 35%, 35% and 24%.

In March 2019, Rothesay sold its €140m portfolio of Irish annuities to Laguna Life DAC in order to ensure that these customers continue to receive their pensions post-Brexit.

In March 2018, Rothesay Life and the Prudential Assurance Company Limited (PAC) entered into a reinsurance transaction covering a £12bn portfolio of annuities, with the expectation that this would be followed by a Part VII transfer. However, even though neither the PRA nor FCA objected to the transfer, in August 2019 the High Court declined to sanction the transfer, and Rothesay state that whilst this is not the preferred or optimal outcome for either party, the reinsurance transaction agreements do contain provisions to address this outcome. Rothesay and PAC have lodged a joint appeal against this High Court decision which is expected to be heard in H2 20.

Detailed credit considerations

Moody's rates Rothesay Life A3 for insurance financial strength, which is in line with the adjusted scorecard-indicated outcome as shown in the Moody's scorecard (Exhibit 4).

Insurance financial strength rating

The key factors currently influencing the rating and outlook are:

Market Position and Brand: Good market position in bulk annuities with significant growth in 2019, although relatively small player within overall UK market

Despite its recent history, Rothesay has become one of the established UK insurers in the growing and relatively concentrated bulk annuity market with annuity AUM of around £54 billion as at YE19. During H2 19, the Group's AUM materially increased with Rothesay completing a number of very large bulk annuity deals. We view Rothesay's ability to execute deals of this size as credit positive for its bulk annuity franchise especially in the largest scheme segment where Rothesay is one of the few active participants and barriers to entry are high. Rothesay wrote a considerable around £16 billion of bulk annuity business during 2019 meaning that its share of the UK bulk annuity market rose from around 5% (excluding the acquisition of the £12 billion annuity portfolio from Prudential plc) in 2018 to around 40% in 2019.

In May 2020, Rothesay said that despite remote working because of the coronavirus, it had executed or was exclusive on over £750 million of new bulk annuity business. Going forward, the Group is well positioned to take further advantage of the rising demand for UK bulk annuities which we regard one of the best long-term structural growth opportunities across the entire European insurance sector.

Rothesay has also become a leading acquirer of life insurers' legacy books of business, as demonstrated by its acquisition of the £6 billion and £12 billion annuity portfolios from Aegon N.V. (A3 senior unsecured, stable) and Prudential Public Limited Company (A2 senior unsecured, stable) in 2016 and 2018 respectively. Nevertheless, Rothesay remains a relatively small player within the context of the overall UK life market, and as a result of its focus on larger pension schemes and back book acquisitions, its new business volume will remain lumpy and less predictable than more diversified peers.

Distribution: Diversity restricted by reliance on Employee Benefit Consultants

Rothesay's bulk annuity business is sourced via Employee Benefit Consultants (EBC) which significantly limits its diversity of distribution. However, Rothesay's control of distribution benefits from its specialist nature and track record within the concentrated UK bulk annuity market. Furthermore, its ability to acquire further back book portfolios is especially enhanced by its execution of the large Aegon and Prudential transactions.

With regard to the distribution of its equity release mortgage (ERM) products, Rothesay relies on specialist brokers.

Product Risk and Diversification: Constrained by focus on UK annuities

A credit challenge for Rothesay is that its business and geographic diversification is constrained by its focus on UK annuities, which dominate the Group's liabilities. As such the Group has significant exposure to longevity risk although at YE19 it ceded 78% of this to reinsurers via the use of unfunded longevity swaps with collateralization features to protect against counterparty defaults. Such reliance on reinsurance is a potential long-term risk, but at least in the short to medium term, we see a continued appetite amongst reinsurers to take on longevity exposure. Rothesay is also active in hedging the inflation risk derived from its annuity portfolio.

Rothesay has also been growing its ERM business which in 2019 generated £694 million (YE18: £1,380 million) of new business volume for the Group. ERM business is viewed by Rothesay and its UK life peers as an attractive asset class in relation to matching illiquid annuity liabilities - at YE19 ERM represented around 5% of Rothesay's investment portfolio.

Asset Quality: Benefits from relatively conservative investment portfolio and lack of intangible assets, but asset leverage very high

Rothesay's asset quality benefits from its lack of intangible assets and relatively conservative investment portfolio. At YE19, the portfolio was invested 33% in gilts, government and supranational bonds, 14% corporate bonds, 14% secured residential lending, 11% other secured lending, 10% cash, infrastructure 9%, ERM 5%. The Group has also recently started to invest in Dutch mortgages.

Rothesay's asset strategy is to minimise credit default risk and secure an illiquidity premium through investing in low risk asset classes and assets with collateral security and other structural mitigation. The high risk asset (HRA) metric at 93% (YE18: 86%) at YE19 is driven by the inclusion of unrated assets the vast majority of which relate to residential mortgages that are not individually rated. At YE19, Rothesay changed its reporting such that its exposure to credit risk by rating now includes the Group's internal ratings on externally unrated assets which are largely illiquid in nature - before this change, the YE18 HRA metric was 253% which included these externally unrated assets.

More negatively, Rothesay's invested asset leverage at YE19 was very elevated at around 19x total equity, meaning that relatively small exposures in relation to the overall investment portfolio become much larger when related to the Group's capital. However, asset leverage, which was around 26x at YE17, has reduced in recent years benefiting from an enhanced capital base via capital raises and retained earnings.

Notwithstanding the good match they provide for the Group's illiquid annuity liabilities, Rothesay also has a meaningful proportion of its asset portfolio in more complex and illiquid investments, some of which are not externally rated and are subject to legislative risk (e.g. the government's planned reform of the leasehold market could have an adverse impact on the Group's loans secured on ground rents). The Group is also generally very reliant on obtaining matching adjustment approval for its investments.

Capital Adequacy: Solvency II ratio improvement in 2019 and resilience during 2020, although target range relatively moderate compared to peers

At 31 March 2020, Rothesay reported an estimated Solvency II ratio of 183%, down from 202% at YE19, negatively impacted by coronavirus-induced market volatility. However, if all management actions before and after quarter-end, including realigning hedges between funds, are incorporated as if in place on 31 March 2020, the Solvency II ratio increases beyond the YE19 level to 204%. This level of solvency is higher than the Group's Solvency II target range of 130-150% which we view as relatively moderate compared to UK life peers.

At YE19, the Group's Solvency II ratio increased to 202% (YE18: 181%). To support its substantial business growth, Rothesay received in 2019 a £700 million equity injection from its shareholders and issued £300 million and £400 million of Tier 3 and Tier 2 subordinated debt respectively. These amounts boosted Rothesay's own funds and helped offset higher capital requirements from its new business and economic conditions, although the quality of its Solvency II capital was somewhat diluted. For Solvency II, Rothesay currently adopts a partial internal model which is used for calculating the solvency capital requirement (SCR) in relation to Rothesay's spread and counterparty risk only.

Notwithstanding the overall close matching of the Group's assets and liabilities and use of interest rate hedging, the Solvency II ratio, not allowing for management actions post-31 March 2020, is relatively sensitive to interest rate movements with a 100bp reduction/increase reducing/increasing the ratio by 32%pt/24%pt as at 31 March 2020. Another main sensitivity is inflation for which a 100bp increase would reduce the ratio by 21%pt, although the impact of interest rate and inflation movements can off-set each other to some extent.

Profitability: Expected to remain at a good level albeit to be somewhat volatile

Rothesay’s return on capital (ROC) performance has been strong averaging around 13% over the last five years. This is notwithstanding the ROC reducing to 3% in 2018 (YE17: 11.6%) which in turn has impacted the 5-year average Sharpe ratio, which measures volatility and at YE19 remained relatively low at 180% (YE18: 183%). However, following the significant decline in 2018, the Group's net income increased sharply during 2019 to £516 million (YE18: £85 million) with ROC improving to c.12%. This was driven by a significant increase in new business profit, favourable financial markets, and the successful investment of assets received as part of the Prudential transaction in 2018 according to the Group's long-term business strategy.

Going forward, we expect the Group’s 5-year average ROC to be constrained by the increased capital base in recent years, but overall profitability to remain at a good level. Furthermore, 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 (£909 million and £273 million at YE19 and YE18 respectively) 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.

Liquidity and Asset/Liability Management: Good liquidity and ALM capabilities

Rothesay’s liquidity benefits from its illiquid annuity liabilities and sources of liquidity such as money market funds, gilts, reverse repos, and its committed revolving credit facility (undrawn as at YE19) which increased to £420 million from £300 million in July 2019. The use of derivatives and resulting collateral calls is the most material driver of liquidity risk for Rothesay but the Group has a robust liquidity management framework and maintains liquidity buffers to withstand stress sensitivities.

The Group’s ALM benefits from its holistic and fully integrated ALM technology which enables it to monitor its key financial metrics on a real-time basis. And interest rate risk is reduced by the very close matching of assets and liabilities in the Group’s annuity portfolio and the use of swaps and swaptions.

Financial Flexibility: Increase in leverage metrics in 2019 following reduction in 2018

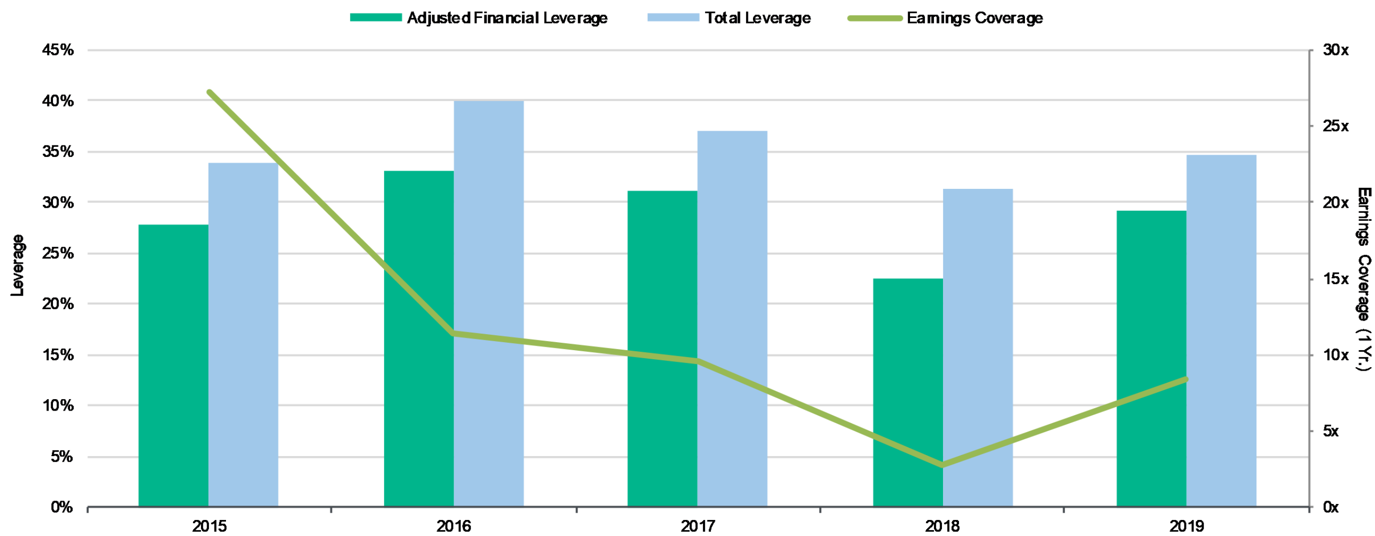
During 2019, our adjusted financial and total leverage metrics for Rothesay increased to 29.1% (YE18: 22.5%) and 34.6% (YE18: 31.4%) respectively following a reduction in 2018, although leverage remains comfortably within our A rating range for financial flexibility. The increase was driven by the Group's subordinated debt issuances during 2019, both of which we treat fully as debt.

In 2019, Rothesay increased its earnings coverage, excluding interest payable on collateral and collateralised agreements, to a relatively high 8.4x following the reduction to 2.8x in 2018. Coverage has benefited from the improved earnings during 2019 although will be constrained somewhat by the additional c.£10 million and £22 million of interest expense from the Tier 3 (coupon 3.375%) and Tier

2 issuances (coupon 5.5%) respectively, together with the £350 million of Tier 1 securities (coupon 6.875%) issued by Rothesay in September 2018. Going forward, we expect Rothesay's earnings coverage to be at a good level.

Although the Group is not listed which somewhat constrains financial flexibility, we expect Rothesay to continue to benefit from the support of its three main shareholders which injected £380 million of capital in 2018 (to partly fund the Prudential transaction) and £700 million in 2019 to fund new business.

Exhibit 3
Financial Flexibility



Sources: Moody's Investors Service and company filings

Environmental, social and governance considerations

Social

Like its life insurance peers, Rothesay faces social risks through the handling of customer information, and the underwriting and business growth implications (positive and negative) of changing demographics.

We also regard the coronavirus outbreak as a social risk under our ESG framework, given the substantial implications for public health and safety. Furthermore, the rapid and widening spread of the coronavirus outbreak, deteriorating global economic outlook, falling oil prices, and asset price declines are creating a severe and extensive credit shock across many regions and markets including the insurance and asset management sectors. While the breadth and severity of the shock in still uncertain, we expect it will have a negative impact on Rothesay's earnings and capital, at least in 2020.

Governance

Like all other corporate credits, the credit quality of Rothesay is influenced by a wide range of governance-related issues, relating to financial, managerial, ownership or other factors, all of which can be exacerbated by regulatory oversight and intervention.

However, Rothesay operates within a strong regulatory environment, being overseen by the UK's PRA.

Exhibit 4

Rothesay Holdco UK Limited

Financial Strength Rating Scorecard [1][2]	Aaa	Aa	A	Baa	Ba	B	Caa	Score	Adj Score
Business Profile								Ba	Baa
Market Position and Brand (15%)								Baa	A
-Relative Market Share Ratio				X					
Distribution (10%)								Baa	Baa
-Distribution Control				X					
-Diversity of Distribution				X					
Product Focus and Diversification (10%)								B	Baa
-Product Risk						X			
-Life Insurance Product Diversification						X			
Financial Profile								A	A
Asset Quality (10%)								A	A
-High Risk Assets % Shareholders' Equity			92.6%						
-Goodwill & Intangibles % Shareholders' Equity	0.0%								
Capital Adequacy (15%)								Baa	A
-Shareholders' Equity % Total Assets				4.4%					
Profitability (15%)								A	A
-Return on Capital (5 yr. avg.)	13.0%								
-Sharpe Ratio of ROC (5 yr.)				179.7%					
Liquidity and Asset/Liability Management (10%)								Aaa	A
-Liquid Assets % Liquid Liabilities	X								
Financial Flexibility (15%)								Aa	A
-Adjusted Financial Leverage		29.1%							
-Total Leverage			34.6%						
-Earnings Coverage (5 yr. avg.)		11.9x							
-Cash Flow Coverage (5 yr. avg.)									
Operating Environment								Aaa - A	Aaa - A
Preliminary Standalone Outcome								A3	A3

[1]Information based on IFRS financial statements as of fiscal year ended December 31, 2019. [2]The Scorecard rating is an important component of the company's published rating, reflecting the standalone financial strength before other considerations (discussed above) are incorporated into the analysis.
Source: Moody's Investors Service and company filings

Structural considerations

The Baa1 issuer rating assigned to Rothesay Life is consistent with Moody's standard notching practice for senior debt issued by insurance operating companies.

The Baa2 issuer rating assigned to Rothesay Holdco is consistent with Moody's practice of applying narrower notching for certain insurance groups domiciled in locations with enhanced regulatory supervision at a group-wide level. Rothesay Holdco, which is the ultimate holding company of the Rothesay Group, is domiciled in the UK and subject to group supervision under the Solvency II regime at a group-wide level.

Ratings

Exhibit 5

Category	Moody's Rating
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

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